"CURRENT TRENDS IN THE RUSSIAN FINANCIAL SYSTEM"

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CURRENT TRENDS IN THE RUSSIAN FINANCIAL SYSTEM

Editor: Morten Balling;
Authors: Stephan Barisitz; Zeljko Bogetic; Zuzana Fungačova and Laura Solanko; Peter Havlik; Valery Invushin, Vladimir V. Osakovsky and Debora Revoltella; Alexander Lehmann; Ewald Nowotny; Cyril Pineau-Valencienne; Pekka Sutela

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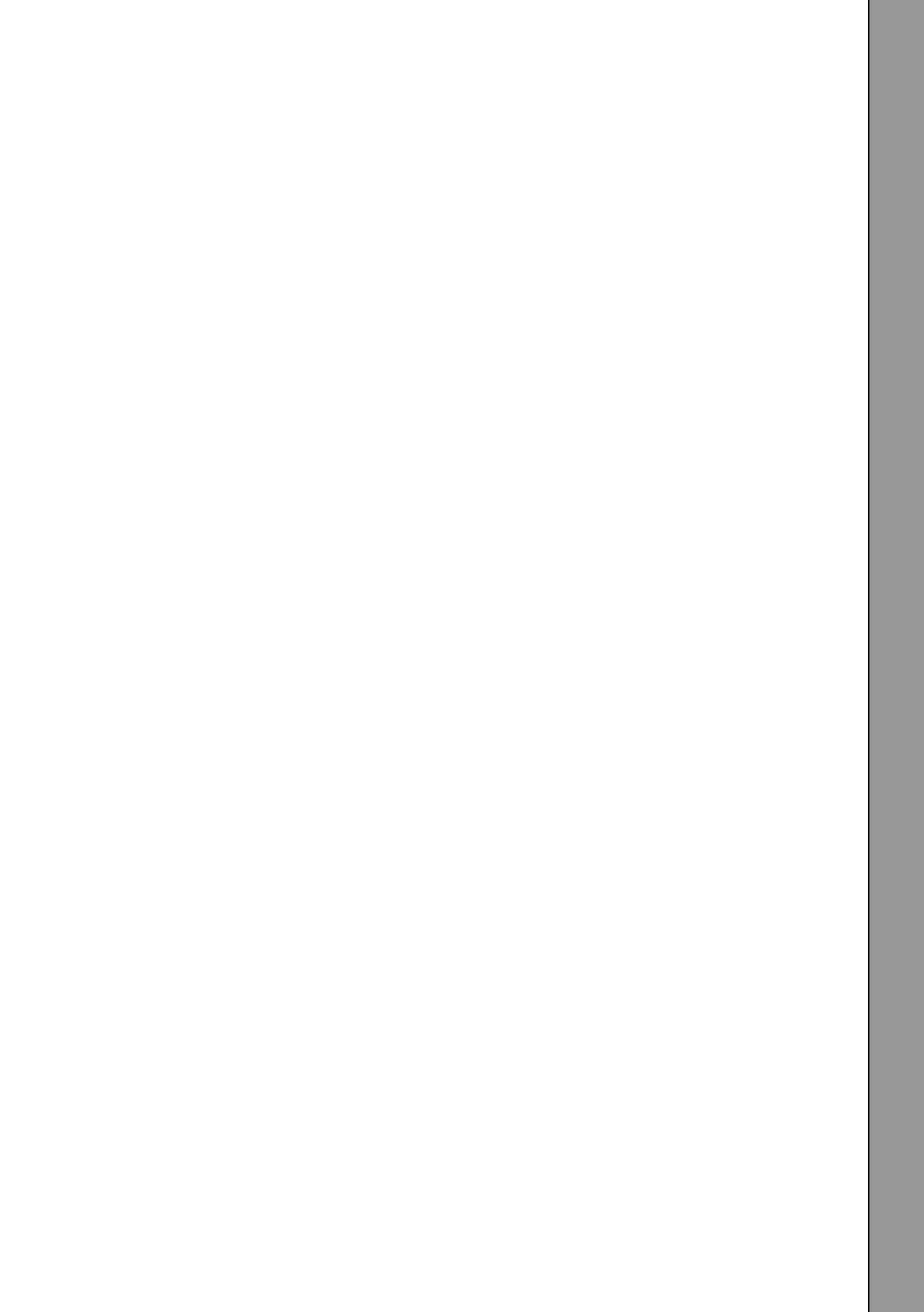


1. Introduction

The papers in the present SUERF Study is a selection of the papers presented at a SUERF Workshop and Special OeNB East Jour Fixe held at Oesterreichische Nationalbank in Vienna on 23 January 2009.

In his opening remarks (chapter 2), *Ewald Nowotny,* Governor of the Oesterreichische Nationalbank referred to Austrian banks' engagement with neighbouring Central and Eastern European Countries. The current crisis should not make people forget the fact that Austrian banks' deep engagement with the neighbouring countries is one of the success stories in Austrian economic history. Since the fall of the Berlin Wall, Austrian banks have become one of the driving forces of the process of structural adjustment, modernization of business practices, and deepening of financial intermediation in the region. At end 2007, in Central Europe, the share of Austrian banks surpassed a fifth of aggregate sector assets, in Southeastern Europe even a third of the respective total. A considerable share of the earnings of Austrian banks comes from banking activities in Central and Eastern Europe. Austrian bankers can claim to be among the pioneer foreign investors in Russia, Ukraine, Kazakstan and Belarus. The international financial crisis has from September 2008 demonstrated Russia's structural vulnerability. The comprehensive countermeasures by the Russian authorities to assist the banking sector and the economy are characterized by the Governor as worthy endeavours.

Chapter 3 is based on the keynote speech by *Pekka Sutela,* BOFIT, Bank of Finland "Russian Finance: Drag or Booster for Future Growth?" The author praises the Russian authorities for having made prudent decisions in recent years. The Putin-Kudrin regime chose a stability-oriented macro policy. The very strong increase in the global oil price up to 2008 implied a strong growth in the value of Russian exports and lead to an impressive GDP growth. The author uses the term "windfall". The Russian Government decided to pay back practically all foreign debt, much of it ahead of schedule. The regime wanted to bring back what they see as Russian sovereignty and in particular to avoid being dependent on IMF or other foreign financiers. Their policy contributed strongly to an improvement of Russia's general credit-worthiness and to a growth in foreign reserves. During the 1990s, lack of trust in the rouble had as consequence that the US dollar was applied to a considerable extent in payments between Russians. The stability oriented policy after 2001 contributed to a de-dollarization of the economy up to 2008.

It follows from the stability-oriented policy that Russia was relatively well prepared when it was hit by the global financial crisis in 2007–2008. In the autumn of 2008, however, the general public started to withdraw bank deposits and the relative share of foreign exchange deposits increased again. The public shifted towards foreign currency cash assets.

The author explains that Russia has a dual economy. The natural resource based sectors are clearly globally competitive but the sectors outside the resource sectors are not. The big resource based companies have relied on foreign markets for their financial needs. The home market is primarily serviced by domestic banks. At the end of September 2008, government-controlled banks had 47.8% of all bank assets. The state maintains banking sector stability primarily through state banks.

The author's answer to the question in the headline is: "The Russian financial system is rather a drag than a booster for future growth". In addition, it is unlikely that Russia will become a regional financial centre or an invention-based society in the foreseeable future.

Chapter 4 by *Stephan Barisitz,* Oesterreichische Nationalbank, is "Russian Banking in Recent Years: Gaining Depth in a Fragile Environment." The author shows tables with macroeconomic, monetary and financial indicators for Russia for the years 2002–2008. Key observations are: Strong economic growth, strong dependence on oil prices, inflation problems, recent volatility of private capital in- and outflows. Banking development initially featured rather slow recovery from the financial crisis of 1998, coupled with sluggish reforms. This was followed by a stepped-up pace of institutional and structural adjustments in 2003–2005, which brought about major improvements of banking activities and of the regulatory framework. The return on equity (ROE) of banks was in 2006–2007 above 20%. The solvency ratio of banks declined steadily up to 2008 due to strong growth in bank assets.

The oil price driven improvements in Russia's terms of trade over the period 1998 to 2008 combined with political stability, prudent macroeconomic policies and some successful institutional and structural reforms have supported Russian economic expansion. Not only exports, but also consumption, have driven strong GDP growth.

Financial intermediation continued to deepen swiftly in Russia up to the fall of 2008, despite important repercussions of the US subprime crisis. As the interbank market tightened during 2008 and capital outflows increased,

Central Bank of Russia reacted quickly with repeated liquidity interventions. Following the continuous oil price decline and pressures on the rouble, Central Bank of Russia intervened extensively in the foreign exchange market and draw down foreign exchange reserves. The controlled depreciation strategy initiated in November 20078 has not stopped the decline in foreign exchange reserves.

Due to the still sizable foreign reserves, the relatively high profitability of banking activity and the satisfactory capital adequacy level as shock absorbing factors, Russia seems to be in a better position to handle the financial crisis than many other countries.

Chapter 5 by *Alexander Lehmann,* European Bank for Reconstruction and Development has the headline "Banks and Financial Reform: Their Role in Sustaining Russia's Growth." The paper focuses on the strength of the link between economic growth and financial development. Even in East European transition countries where a positive correlation between finance and growth developed in the 1990s, there was little microeconomic evidence that the financial sector actively supported growth. Investments were overwhelmingly financed through retained earnings, and what little external finance was raised came from foreign direct investment. Around year 2000, this changed. Regulatory improvements, better enforcement and rapid development of individual institutions meant that the financial sector undoubtedly has supported economic growth since year 2000. The disruption to credit growth since 2008 and the simultaneous downturn of the Russian real economy has made the link abundantly clear. EBRD evaluates the progress in structural reforms in transition countries by means of "transition scores". The author shows an exhibit which illustrates the development of the EBRD transition score for Russia from 1989 to 2006. It shows that the fastest progress took place from 1995 to 2003. The improvements in the regulatory framework for banking activity supported financial intermediation and Russian banks expanded their balance sheets and diversified into lending to retail customers and SMEs. For corporate investment as a whole, however, the share of new investment financed through bank credit remained relatively small. The sectors that saw sharp increases in investment and accounted for the bulk of capital spending, predominantly benefited from internal cash flows, or benefited from public support or ownership.

Chapter 6 by *Cyril Pineau-Valencienne,* CEO, CPV Conseil, is "Russian financial institutions and the oil and gas sector: funding and recycling." The paper first outlines the importance of the oil and gas sector for the Russian

economy. Capital expenditures in the sector grew strongly from 1999 to 2007. The huge investments were to a large extent financed by internal operating cash flows and by borrowing in international financial markets. The big oil and gas companies are important customers for foreign banks. The companies also have their own so-called raw material banks but these banks have not played a major role as related parties in the financing of the investments of these groups. The willingness of the oil and gas companies to incur debt denominated in foreign currency must be understood in the light of their revenue structure. Contracts in the global energy markets are primarily denominated in US-dollars and the companies are therefore to a considerable extent able to match currency revenues from exports with currency payments of principal and interest. Recycling of funds related to the oil and gas sector has partly been carried out by the state and by the sovereign funds controlled by the state. Revenue from export duties has been accumulated in the funds and applied in accordance with the funds' investment strategies.

Chapter 7 is based on the presentation by *Zuzana Fungáčová,* BOFIT, Bank of Finland "Risk-taking by Russian banks: do location, ownership and size matter?" The paper is co-authored by *Laura Solanko.* The rapid growth of the assets of Russian banks has in the last 6–7 years contributed to a decrease in the capital adequacy ratio, thus influencing the ability of banks to cope with risk. In the paper, the authors investigate the relationship between bank characteristics and risk-taking. The banks are divided into different sub-groups by size, ownership and location. The authors distinguish between state-controlled, foreign-controlled and domestic private banks. Risk is measured in two different ways: By group-wise comparisons of financial risk ratios i.e. accounting data, and by regression analysis of bank insolvency risk as measured by a Z-score indicator. The average level of financial ratios are all well above the regulatory minima set by Central Bank of Russia. Large banks in Russia have higher insolvency risk than small ones. Foreign-owned banks exhibit higher insolvency risk than domestic banks. State-controlled banks are on average more stable than the private domestic banks. Similar to the case of foreign banks, large state-controlled banks are more stable than the others. Regional banks are significantly more prone to risk-taking than their counterparts in Moscow.

Chapter 8 is based on the keynote speech "Russia's Financial Crisis: Causes, Consequences, and Prospects" by *Zeljko Bogetic,* World Bank, Moscow. Until mid-2008, Russia was viewed as a "safe haven" during turbulent times in global financial markets. Record high oil prices, strong macroeconomic fundamentals, lack of exposure of Russian banks to the US sub-prime

mortgage markets, strong ratings and a strong appreciating currency explained the confidence in Russia. After mid-2008 Russia was hit. There was an oil price shock, a sudden stop in capital flows, and a sharp tightening of external borrowing conditions. The paper contains a diagram that documents an almost perfect correlation of the Russian stock index RTS with the price of oil. From the peaks in May-June 2008 to the end of the year, the RTS moved from 2400 to 440 and the oil price from USD 144 per barrel to USD 45 per barrel. The non-oil external current account deficit continued to deteriorate very fast in 2008 as import volumes grew faster than non-oil exports. Incoming FDIs declined and worsened the composition of capital flows towards borrowing. While public external debt remained moderate, private (corporate and bank) debt grew rapidly. In the balance sheets of Russian banks, the loan-deposit ratio increased from approximately 107% in 2005 to 127% in the autumn of 2008, making the banking sector more exposed to the interbank market and to rollover risk. As response to the crisis, the Russian authorities have loosened their monetary stance and provided fiscal support to ease the liquidity crisis. The exchange rate has continuously been managed with progressive widening of the bi-currency corridor. After a gradual depreciation since November 2008, the rouble was devalued in mid January 2009.

The speaker described the 2009 outlook for the Russian economy as very uncertain. It is likely that the twin surpluses on the Government budget and the balance of payments current account will disappear, but thanks to the prudent macroeconomic policies in recent years, these deficits can be financed for some time. The speaker reflected on the social impact of the crisis. If the recession in 2009 becomes deeper, it might require an introduction of a fiscal stimulus package focusing on domestic demand and the poorer segments of the population, including strengthening of the unemployment, training and social assistance and possibly well designed public works.

Chapter 9 is based on the presentation by *Peter Havlik,* The Vienna Institute for International Economic Studies (WIIW) “Russian Economy and the Global Turmoil.” The paper contains very illustrative exhibits that show the development of Russian GDP, exports, imports, inflation, money supply, stock prices and nominal and real exchange rates. Among the Putin administration’s key achievements, he lists improved living standards, rising employment, more FDI inflows, repayment of external debt, ballooning foreign exchange reserves, restoring stability, stronger role of the state but also deteriorating external relations. Despite strong economic fundamentals, Russia has been seriously hit by the global crisis. The Medvedev administration faces serious challenges. It plans to use industrial policy instruments in order to

reduce the dependence on energy proceeds. The Government offers targeted support to various public-private partnership projects in the automotive, aviation, shipbuilding and selected high-tech industries. According to the speaker, some of the envisaged industrial policy tools could well be in conflict with WTO rules and make Russia's WTO accession more difficult.

Chapter 10 is based on the workshop contribution by *Debora Revoltella,* UniCredit Group "The Russian Banking Sector: What to Expect? The paper is co-authored by *Vladimir V.Osakovsky* and *Valery Invushin.* It is divided in three sections: 1) The past: Russian economic renaissance, 2) The crisis: Politics and Economics join forces, and 3) Longer term prospects are brighter. Up to 2008, Russia enjoyed strong growth in domestic investment, consumption and GDP. Prudent fiscal policy and massive capital inflows helped to amass the world's third largest international reserves. The country was, however, exposed to global commodities prices, a demographic crisis, a rigid labour market and an increasing dependence on foreign sources of funding. The crisis in 2008 was triggered by collapse of global commodities prices, massive capital flight, failures of some large market participants and general loss of confidence abroad and at home. As reaction to the challenges posed by the crisis, the Government and Central bank of Russia initiated corporate debt refinancing assistance, liquidity infusion into the banking system and fiscal stimuli. The authors expect a major restructuring of the Russian banking sector including a considerable reduction of the number of financial institutions.

Morten Balling
Aarhus, March 2009

2. Opening Remarks

Governor Ewald Nowotny

Ladies and Gentlemen,

I am very pleased to welcome you to this workshop jointly organised by SUERF – The European Money and Finance Forum – and the Oesterreichische Nationalbank. As many of you may know, SUERF and the Oesterreichische Nationalbank have cultivated close ties for many years, with the OeNB hosting the SUERF General Secretariat for almost a decade now. It is therefore a great pleasure for me to see that this close cooperation again takes concrete shape in today's conference.

SUERF – pivotal in bringing together academia, policy makers and practitioners

What I like particularly about SUERF is that it constantly invests its efforts into bringing together academics, practitioners from the financial industry and policy makers, notably central bankers and supervisors. The current financial and economic crisis highlights the extreme importance of such close co-operation and exchange of views among these three constituencies.

– Central bankers and supervisors need the originality and innovative spirit of academic researchers. Constant contact with the "real world" of financial practitioners is central for the authorities' ability to steer the financial and economic system safely both in good – and not so good – times. The need for orientation and direct help to the markets from the authorities has rarely been as big as now.

– Particularly in the rapidly-changing world of finance, academics need close ties to the financial practitioners, in order to form a relevant research agenda. Constant exchange with monetary and supervisory authorities stimulates new academic research and provides opportunities to have an impact on policy.

– Finally, today's highly developed and complex financial industry crucially depends on concepts and techniques developed by academic researchers. Close contact with monetary and supervisory authorities allows financial practitioners to raise their concerns and problems, while at the same time offering them insights into the larger motivations of monetary policy and regulatory measures.

Particularly in times of crises, it is quintessential to pool all available brains and skills to find ways how to cope with pressing problems in the short run and to devise a system which will be less prone to disruptions and crises in the future. Before focusing on the topic of this event, let me just say some words about the Oesterreichische Nationalbank's own efforts at strengthening links with our large neighboring region Central, East and Southeastern Europe (CESEE) – including the Russian Federation.

The OeNB – an internationally recognized competence center for Central, Eastern and Southeastern Europe

I am proud to underline that the OeNB itself has become an internationally recognized competence center for this important region by supporting European economic integration and development of financial markets through the provision of extensive accurate analysis, technical assistance and opportunities for dialogue. To give a concrete example that comes at the right time: The ECB, together with nine national central banks – including the OeNB – participated in an EU-funded TACIS project which provided training to 400 staff members of the CBR and was designed to strengthen banking supervision in Russia. The project was launched in November 2003 and lasted two years. The follow-up Eurosystem-CBR program started in May 2008 and is focusing on training for CBR internal auditors.

Active networking, cooperation with and exchanges of experts are re-inforcing the OeNB's position in the region, which is so important to my country's interests, and can promote strategic partnerships. The OeNB publishes a number of refereed journals that have gained solid reputation in recent years, in particular the Focus on European Economic Integration (formerly: Focus on Transition) and the Financial Stability Report, which prominently cover CESEE territory. We also organize and host conferences. Today's East Jour Fixe is such an example. This is a one-day event devoted to elucidate a specific topic, like today, trends in the Russian financial sector.

We are so pleased to organize this conference jointly and therefore also as a SUERF Workshop, benefiting from the expertise of our partners.

Austrian banks' engagement with neighboring CESEE: a success story

But now let me turn to the topic of this event. Despite the repercussions of the US and global financial crisis on CESEE, which are already dampening growth and triggering turbulences in countries with important macroeconomic and structural imbalances, in my opinion there can be no doubt that this region remains on a long-term investment-driven growth path. It continues to harbor major catching-up potential, whose realization will continue to proceed, even if interrupted or slowed down from what was expected just half a year ago.

Let's go from the – partly extreme – volatility of business cycles to – more robust – structural adjustment. I remain solidly convinced that Austrian banks' deep engagement with neighboring CESEE constitutes one of the success stories of my country's economic history. More precisely: Relatively soon after - and some cases even before - the fall of the Berlin Wall, Austrian credit institutions established their presence in Central, Eastern and Southeastern European markets. In the following years they strengthened their competitive positions, and became one of the driving forces of the process of structural adjustment, modernization of business practices, and deepening of financial intermediation in the region.

Three large Austrian banking groups (incl. Bank Austria, which is owned by UniCredit) - namely Erste, Raiffeisen and Bank Austria itself – occupy three of the four highest ranks in terms of total assets among banking groups active in CESEE. Austrian credit institutions have been largely spared from the immediate effects of the subprime crisis that broke out in August 2007 thanks to their retail banking business model and specifically to their strong engagement in CESEE. At end-2007, in Central Europe, the share of Austrian banks surpassed a fifth of aggregate sector assets, in Southeastern Europe even a third of the respective total. In the largest CIS countries, Austrian banks' share only comes to about 6%, but here too, Austrians have been among the first movers as foreign strategic investors.

The outstanding importance of CESEE for credit institutions of my country can also be derived from the fact that at end-2007 the share of the region in the consolidated balance sheet of all Austrian banks reached over a quarter

and the corresponding share in the consolidated annual profit exceeded 40%. In the first half of 2008, CESEE's profit share even increased to 80%. In a number of countries of the region, Austrian banks shoulder considerable responsibility with respect to the stability of national financial markets.

Austrian banks also among the pioneers in Russia and CIS markets

CIS banking markets have expanded most dynamically in recent years. While in countries like Russia important banking reform initiatives have been formulated and implemented in recent years, the state as well as domestic financial-industrial groups tend to retain stronger positions than they do in the New Member States (NMS) of the European Union. FDI penetration of CIS banking sectors is weaker. In Russia, foreign investors own about one fifth of the assets of the sector, but the tendency has been rising, at least until most recently. Without going into details, Austrian bankers can also claim to be among the pioneer foreign investors in Russia, Ukraine, Kazakhstan and Belarus. There are currently four Austrian banks active in Russia, which together account for 4% of total Russian banking assets - or over a fifth of all foreign-owned assets. Two are relatively large: Raiffeisenbank (2% of all assets, 8th-largest bank as of end-2007) and UniCredit Bank (almost 2%, 9th-largest).

No doubt that Russia and other CIS countries at least partially participate in a pan-European economic integration process, driven by corporate and banking networks, expanding trade and cross-border financial transactions and even by a degree of legal convergence, where EU regulations tend to be taken at least as benchmarks. This is clearly the case in Russia, where European Union regulatory standards, e.g. with respect to minimum capital requirements and other prudential rules, are key points of reference. Moreover, cross-border cooperation between banking supervision agencies, e.g. through Memoranda of Understanding, constitutes an indispensable integration factor.

Impressive, but risky credit booms in Russia and across CESEE

Supported by the presence of strategic investors and robust economic growth, financial intermediation increased strongly and in some countries, exponentially – if from a modest level of departure. Due to high, if declining interest rate spreads, profitability indicators have remained on a substantially higher level in the CESEE than in the euro area or in Austria. However, higher

profitability goes hand in hand with higher risks. The credit booms have contributed to increased macrofinancial vulnerability, which has expressed itself in additional demand pressures, some symptoms of overheating, and mounting external disequilibria. As to Russia: Given its impressive macroeconomic record and the structure of its economy, in Russia these external imbalances did not show up in growing current account deficits, but in pressure on the country's high current account surpluses through rising import demand and increasingly negative contributions of real exports to GDP growth. Furthermore, buoyant lending became more and more dependent on cheap foreign financing, which pushed up private sector and total domestic external debt. At the same time, Russia's financial balance became more and more volatile, including sizable and recurrent capital outflows.

Russia's macroeconomic strength and structural vulnerability facing the aggravation of the international financial crisis from September 2008

Until a couple of weeks ago, Russia's macroeconomic data have been nothing but enviable: buoyant GDP growth in Jan-Oct 2008 (about 7% year on year), impressive twin surpluses, gross official reserves that still cover most of Russia's gross external debt and remain the third-largest of the world. And Russia's banking sector featured relatively robust pre-crisis indicators. As I see it, the vulnerability of Russia's financial system, may have been heightened by two major factors: first, the steep oil price decline; second, the country's persisting limited attractiveness for FDI (e.g. in 2007, total net FDI inflows have been measured at less than 1% of GDP - despite the country's daunting potential). While the first factor reflects Russia's lasting economic dependence on exports of energy and of a few other commodities, and therefore, its susceptibility to boom-and-bust cycles, the second factor emerges from the country's persisting weak investment climate and insufficient rule of law, and is partly responsible for the banking sector's dependence on debt-creating and volatile capital inflows.

The authorities' comprehensive countermeasures to assist the fragile banking sector and economy: a worthy endeavor

Once the crisis had triggered a major re-pricing of risks, an all-out drying up of liquidity, and a global economic downturn which sent the oil price on a declining path, it was difficult to resist the downward momentum.

Having a strong financial arsenal at their disposal, the Russian authorities did massively resist. In September-October 2008, the authorities issued a large number of measures estimated at a total of EUR 150 billion (about one sixth of Russian GDP) to inject liquidity, recapitalize banks and issue guarantees. This package seems to have - at least temporarily - stabilized the situation. CBR interventions to prop up the ruble following accelerated capital outflows, financial assistance to credit institutions and enterprises, but also forex valuation effects, are responsible for the shrinkage of official reserves from early August to end-December 2008 by over one fifth (to still generous EUR 313 billion).

In October and November deposit withdrawals from several banks, incl. some larger ones, went on despite government measures. Given the deep downward slide of oil and other raw material prices, the ruble has been under intensified pressure in recent weeks. With the very painful experience of the ruble's 1998 collapse in mind, the authorities have opted for a controlled devaluation strategy and have since mid-November 2008 engineered a number of widenings of the ruble's corridor against the dollar/euro currency basket. These have been complemented by some interest rate increases to stem capital flight. Whether this strategy will be successful and not "burn" too much forex reserves, remains to be seen and may depend on when and where the oil price will find its floor.

In any case, Russia – in contrast to so many other countries – still retains a generous financial cushion that it has so far been striving to use in a sound manner. In the short and medium-term future, Russia's official reserves, wisely used, could just make the difference – also in the defense of its banking sector and financial stability. Barring lasting irrational price dynamics, a period of lower oil prices could even be, if I may say so, a refreshing and invigorating environment and incitement to once again push forward and resume the so much needed structural and institutional modernization of this vast and promising country.

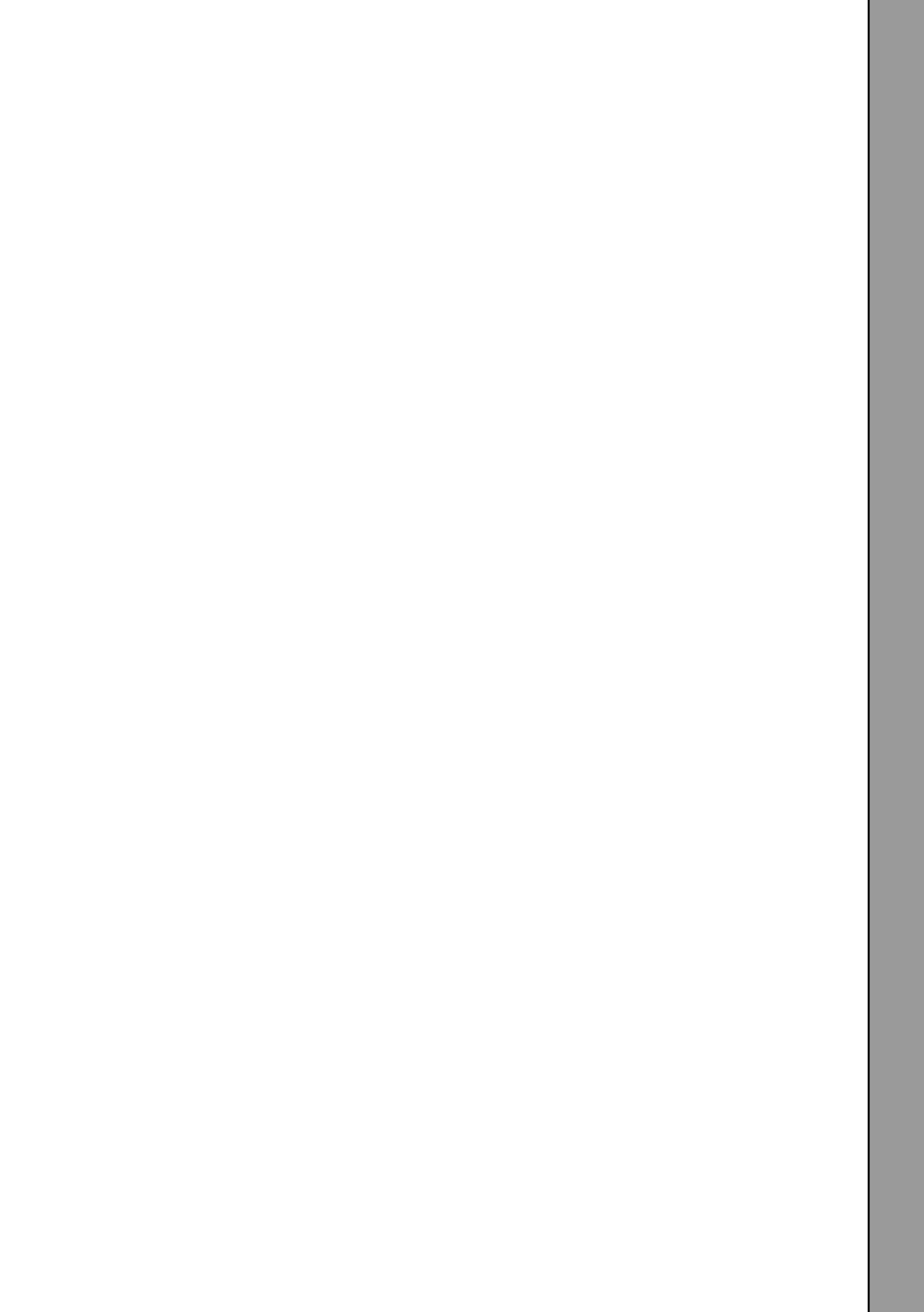
We all need to join our efforts to tackle the crisis

Not only Russia, also Austria and some other countries inside and outside of the European Union have already carried out important and urgent assistance measures. But we are confronted with challenges that none of us can surmount alone. Given the current general and rapid economic slowdown, stabilization of banking systems may well become the priority for governments across the

region, if they want to avoid even more severe consequences. As international financial organizations like the EBRD have pointed out just a couple of days ago, stabilization measures will need to be coordinated with other countries – including Austria's neighbors in Central, Eastern and Southeastern Europe – taking account of the inter-linking ownership structures in the region's financial system. Let's get to work ***– together -*** and tackle the global crisis in our region by strong and coordinated efforts of our central banks, finance ministries, financial supervision agencies and other institutions. We have no time to spare!

In this sense of togetherness and teamwork, may I wish the participants of this conference stimulating and fruitful discussions and productive networking in these extraordinary times.

Thanks for your attention!



3. RUSSIAN FINANCE: DRAG OR BOOSTER FOR FUTURE GROWTH?

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Ladies and Gentlemen,

We are living in interesting times, not least in the sense of the alleged Chinese curse. These are not yet great times. Great times, as you know, are very bad for small people. But whether these remain interesting times or turn into great times, at some point of time they will return to something approximating normal times. The organizers have asked me to consider one aspect of Russia's future return to normalcy. Given that many observers seemed to agree, before the crisis, that Russia's growth potential is currently somewhere around 4 per cent, perhaps as high as five percent, will Russian finance be a drag or booster for future growth?

The question has many aspects, several of which are going to be discussed in great detail and erudition in the presentations to follow. But let me sketch just a few fundamental questions.

Russia's growth has been recently largely driven by consumption. A share of new consumption was financed by credit. Will retail credit be available to help finance the formation of a consuming class, the famous new Russian

[1] Opinions presented are those of the author and do not represent on views of the Bank of Finland. Comments by my colleagues – Mika Erkkilä, Zuzana Fungáčová, Iikka Korhonen, Laura Solanko and Heli Simola – are gratefully acknowledged.

middle class, who are both the consumers and the producers of the deep structural change of the last two decades in the Russian economy? I refer both to the surge in imports and to the emergence of a modern service sector.

For years after the 1998 crisis, growth could be based on increased capacity utilization, though real investment also grew fast since 2006. Future growth has to be investment-based for reasons both of high capacity utilization ratios reached by 2008 and in particular for reasons of lack of competitiveness. How will the Russian financial system perform in its fundamental role of converting savings into investment?

And finally, will Russia actually become a regional financial centre with ruble as one of the reserve currencies? This, after all, was the goal repeatedly set by the Putin administration.

Clearly, I shall be unable to give a full answer to any of these questions. It will be helpful, however, to keep them in mind during today's discussions.

x x x

At the moment, expectations, as reflected in various indexes, in Russia are pessimistic. This reflects a sudden stop in economic growth. During the first half of 2008 growth reached 8.5 per cent, reflecting an overheating economy. December was the first month with a year-to-year decline in GDP, by 0.7 per cent. Retail sales growth, the proxy for consumption, has dropped from above 15 per cent to negative figure, with seasonal adjustment. Real wage growth used to top 15 per cent, it is now down to some 7 per cent. Construction used to be an overheated sector booming at 20–30 per cent annually. Growth is now some 5 per cent. Industrial production dropped about 10 per cent in December, year-to-year. On the other hand, interest rates and bond yields have rocketed up.

Russia was not a safe haven. There had been no decoupling. Even remembering these concepts uttered with evident confidence less than a year ago now tends to produce ironic smiles. Still, safe haven and decoupling are what many also in Russia, but not only in Russia, including at the very highest political level, seem to have believed until about October. The financial crisis was an American creation, the thinking went, and there was no reason why the subprime issue – after all not a huge phenomenon in a global perspective – would come to curse the Russians – or the Germans, for that matter. In the Russian case I and many others also referred to the underdevelopment of the Russian financial

system as a hidden benefit in times of financial crisis. There would hardly be any stock exchange induced wealth effect on household consumption. Less than a million out of the more than 50 million Russian households had, after all, any quoted wealth. Also the impact of finance on real investment would be relatively small. Most investment had been financed from retained earnings or by the government. The share of bank credit in financing real investment was in 2007 9.4 per cent – admittedly, up from the 2.9 per cent in 2000.

We all naturally knew that the intermediation of savings into investment is a key function of the financial system. Therefore, financial deepening is one of the drivers of modern economic growth. True enough, the causality has often been difficult to capture in empirical studies. Does finance drive growth or does growth lead to financial deepening? Also, we knew that fast financial expansion is not always a boon, especially if it combines with slack financial supervision, less than well defined property rights, unproven institutions and short experience of them, large cross-border capital flows and possibly a fixed exchange rate. This after all, had been the combination which has helped practically all transition countries into a financial crisis of one or another kind. To put it short, a financial system does not contribute to economic growth if it fails to convert savings into investment or if it is overly unstable.

Intriguingly, The Banker (Piggott, (2009)) very recently ranked the Russian financial system second in health, after Norway but before Kuwait. Basically, this is a consequence of small size together with very large government reserves.

Russia has been one of the transition countries undergoing a financial crisis. The 1998 collapse of the ruble is still fresh on the memories of both the general public and the decision-makers, though very few of the latter were in positions of responsibility already ten years ago. This is an interesting fact. Acting in a crisis is something one does not learn from textbooks and training seminars.

Figure 1: Russia's Finance in 2000 and 2007

	2000	2007
Federation budget surplus, %/GDP	1.5%	5.5%
Public sector expenditure, %/GDP	35.0%	33.4%
Central bank reserves relative to imports, months	8.0	25.0
Net capital flow	–24.8 USD bn	81.2 USD bn
Foreign currency share of savings	32.5%	13.2%
Public debt, %/GDP	51.2%	3.6%

Financially Russia was in end-2007 a world apart from what it was when Vladimir Putin became the president in 1999/2000. The newly privatized and liberalized Russian economy had reacted to the deterioration of the ruble with a swiftness that surprised me and many others. True, new export commodities did not emerge – a key evidence of the lack of Russian real competitiveness outside the resource sectors, but Russian companies were willing and able to utilize their hugely improved price competitiveness at domestic markets. The economy was also undergoing a deep but all too often neglected structural change, as both imports and domestic producers were for the first time introducing new goods and in particular services.

So, fast growth started before the Putin era. It was based on price competitiveness, improved capacity utilization and the simple fact that new institutions – however imperfect, and that they were and remain – were better than the old ones. And if one were to prefer cultural explanations, there surely was no lack of the capitalist spirit. And as we have the bad habit of equating Russia with oil and gas, it is worth remembering that fast Russian growth started years before the rapid climb of the oil price.

Undoubtedly, the Putin regime was hugely lucky in several respects. There was the price competitiveness created by the 1998 ruble collapse. But there was also a stability-oriented macropolicy consensus based on the bitter experiences of the 1990's. The Primakov-Maslyukov government, put in place after the collapse, was the most left-oriented in recent Russian history. It came to power, promising most of the wrong things. In practice, and contrary to all the promises made, it started a huge fiscal consolidation. In three years, general government expenditure was cut by close to 15 per cent of GDP. And this was more or less acceptable to the voters – in spite of that at the time an opposition of a kind still existed.

The biggest strike of good luck of them all, as we all know, was the rocketing of the basic export price. Oil cost just slightly above 10 USD in Spring–1998 but 140 USD last summer. On the more relevant annual level, oil price was 72 USD in 2007 and 95 in 2008. Though there is still some work to do, gas prices followed. So did those for metals.

Such windfalls are all too often a curse. But after some hesitation, the new regime did wise decisions – and implemented them, always a needed distinction when talking about Russia. The government paid back practically all foreign debt, much of it ahead of schedule. The regime wanted to bring back what they see as Russian sovereignty – being a nation not at the mercy

of cold-eyed and perhaps even hostile foreign financiers – but consequently debt payment also much improved Russia's general credit-worthiness. They accumulated major reserves and increased various government expenditures, but as you will have seen from the first slide, still the share of public expenditure in GDP actually decreased.

Inflation remained high, but it was on a consistent declining trend until autumn 2007, when rising international food prices, higher than expected export revenues, a net capital inflow into the country and emerging signs of an overheating economy turned it up. Still, monetary stability was hugely better than previously. This is also evidenced by prominent de-dollarization in the economy. As just emphasized, the regime was lucky with export prices. But it was also paradoxically lucky in that it inherited an economy with very low monetization. Money inflow into the economy was to a large extent sterilized by running major fiscal surpluses. But it was also matched by increased demand for rubles through de-dollarization, monetization of transactions and emerging financial deepening.

Had this not been the case, preventing very high inflation would have been next to impossible. So, the government was lucky, but it was also determined to contain inflation. The fiscal conservatism of the Putin regime, with Finance Minister Kudrin as the standard bearer, is well worth praising. One understands the frustration still regularly expressed by the political leadership, when they continue underlining that the current crisis, in contrast with the 1998 collapse, was not made in Russia. One also understands why the government – and this in fact is in the competence of the government, not in that of the central bank – has against sound economic logic opted for a step-wise depreciation of the ruble. A one-off devaluation might upset the expectations of economic agents in unpredictable ways, thus risking what the regime sees as its main economic achievement, improved financial stability.

It was announced just yesterday, on 22 January that such step-wise depreciation would give way to a major, 10 per cent one-off widening of the currency band. It remains to be seen whether this might be sufficient to turn expectations towards ruble stability or even appreciation.

Let me re-emphasize something I just said. From a conservative financial point of view the Putin–Kudrin macroeconomic policy line makes great sense. The criticism that other conservatives have to offer is just that the regime was not conservative enough, especially during the last few years,

those of Putin's second Presidential term (Gaidar and Chubais (2008)). Fiscal obligations of a long-term expenditure impact were then adopted.

The grand political point was however not about the exact size of the consolidated budget surplus. It was about sovereignty. The Soviet Union collapsed largely because the country had become addicted to foreign debt, so amply available in the 1980's. Collectivized agriculture was not able to feed the population, and much oil revenue had to be used for buying food. When oil prices duly declined, the only way to attempt out was additional debt – and in particular ever more pleading for assistance for the cause of Perestroika. This should not be repeated.

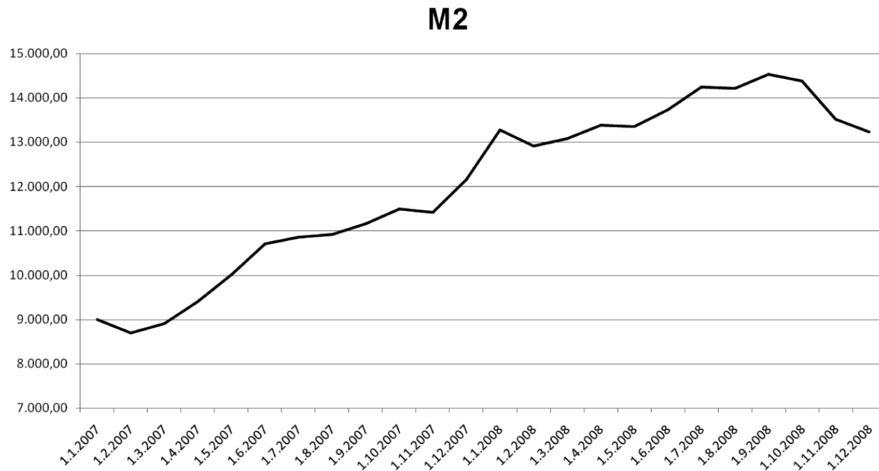
Even less should be repeated the experiences of the 1990's: dependence on IMF programs, ever increasing short-term debt to finance budget deficits, loans-for-shares privatization making the state a hostage of domestic oligarchs, and finally the ultimate humiliation, the 1998 default.

These are the roots of the Putin policy of financial sovereignty. Paying back state debt, accumulating reserves, furthering de-dollarization, lowering inflation, pushing for Russian investment abroad – these are the proudest economic policy outcomes of the regime. And more was to come. Russia set high long-term goals in 2006-2008: continuing fast growth, but now based on innovations, investment, infrastructure and better institutions – in short, on intellect; establishing an independent financial system; making Russia one of the financial centers of the world; and making ruble one of the reserve currencies. But then, the global crisis hit. Small wonder that the first reaction of the regime was a state of denial. But the over-reaching goal of sovereignty remains.

There is reason enough to worry about losing stability. Though a money market panic has been avoided, the general public has started to withdraw savings, 1.5 per cent of the stock in September, 6 per cent October, but just 0.2 per cent in November. The share of foreign exchange deposits has increased from 13.5 to an estimated 20 per cent. Ruble M2 has declined. During first half of 2007, the compound month growth rate of banking assets was 3.6 per cent. During first ten months of 2008, the figure was 2.2 per cent. Clearly, the public has shifted towards foreign currency cash assets. At the same time, first reports have been coming about the return of payment arrears, money surrogates and barter, all phenomena of the 1990's that were thought to have turned into history. After November 2008, two topics have dominated Russian public discussion. Should one expect large-scale political disturbances, especially in

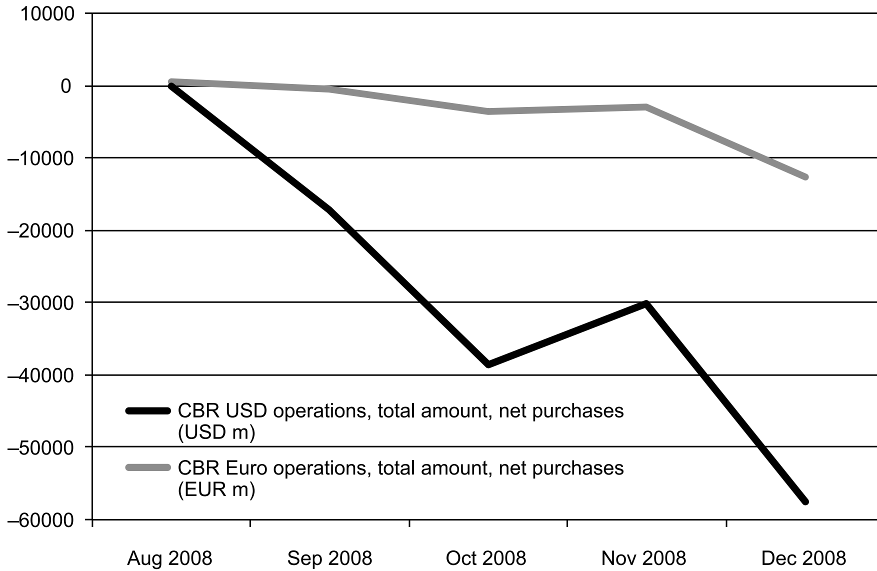
one-company towns? Will step-wise weakening of the ruble in the end – and that end may be quite immediate - lead to a major one-off devaluation?

Figure 2: Ruble M2



One therefore tends to understand why Kudrin and Putin think that their fiscal conservatism has been vindicated. If some liberals criticized excessive public expenditure, there was much more pressure, inside the government and outside it, to use a large share of the windfall for such worthy purposes as infrastructure, education, public health and others. Instead, the government chose to accumulate reserves, though it did adopt additional expenditure commitments recently. As it happens, these reserves have been much needed since summer 2008. But on the other hand, though investment did rise in recent years by up to 20 per cent annually, and there were many signs of overheating, deterioration of human and physical capital has continued, in many respects at least. Over any longer period of time, future economic growth has to be investment-based. There is no return to the conditions of ten years ago. The measured industrial capacity utilization ratio was around 55 per cent in 1998. The economy was able to grow through increased capacity utilization, when price competitiveness surged. Now the capacity utilization ration is over 80 per cent, and a weakening ruble alone will not bring forth a major long-term supply response.

Figure 3: Bank of Russia currency interventions, August – December 2008



The need for an investment-driven growth process is not just based on current high capacity utilization ratios, but also on competitiveness concerns. Russian studies on current competitiveness pinpoint three major conclusions. First, the average productivity level is very low, often just a few percentage points of international best practice. Here Russia is fundamentally on a par with such emerging economies as China and India, but naturally wages and many other costs are notably higher. Second, productivity varies hugely across branches and regions. Third, within branches the share of companies that can currently be characterized as competitive varies from 10 to 40 per cent, with the largest share – according to one study – in petrochemicals.

Figure 4: Competitive indicators for Russia

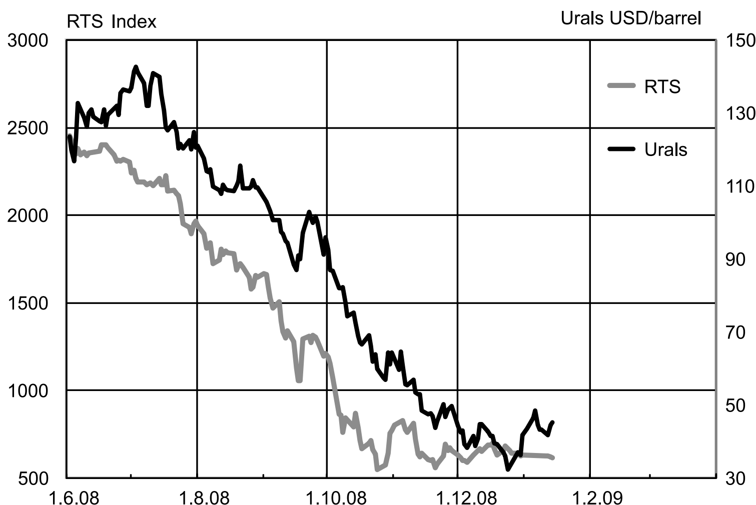
Index	India	China	Russia
Human development	128	81	67
Global competitiveness	48	34	58
Economic freedom	115	126	134
Freedom of speech, 0–100	58.7	5.8	20.2
Corruption	72	72	143
State efficiency, 0–100	57.3	61.1	42.2
Political risks, 0–100	17.8	32.2	23.1

Such competitiveness as exists is typically based on transient factors. Current companies inherited their capital stock basically free of charge in privatization. With an average wage level of some 400 euros, labor remains cheap compared with European levels. Also energy prices – especially gas – are low. The ruble has, in spite of fast real appreciation, been undervalued since the 1998 collapse until quite recently.

Now the capital stock needs badly investment, real wages have been rising by some 15 per cent annually, there is an accepted schedule for increasing domestic central gas tariffs for industry to European levels (and future electricity prices might rise also due to market liberalization), and the ruble exchange rate probably reached something like an equilibrium level in 2008. – That was the picture before the crisis.

How fast growth can we expect in coming years? Curiously, forecasts for short-term Russian economic growth tend to nest very closely. It has been generally accepted that the current potential Russian growth rate is somewhere around 4 per cent, perhaps as high as 5 per cent. Around that level, short-term growth is driven by export prices, well approximated by the oil price. The oil price also drives equity indexes, as you see in Slide 4. Also note that the well published political events of summer 2008 actually failed to make an evident dent in the basic Russian stock index. This is also true of the currency reserves.

Figure 5: Oil price and the RTS index



The following box presents the policy neutral calculations we made back in November 2008, using our small model of the Russian economy. This might be compared with the official Russian forecast, accepted by the government in mid-December 2008. Assuming an oil price of USD 50, and with some adjustment for the expected policy impact, it forecast a growth rate for 2.4 per cent for 2009. Though it was never published, it is understood that there was also an alternative calculation with an oil price of 32 dollars. That associated with a clear decrease in GDP. Many other experts expect at least slight decline of GDP in 2009, even if the oil price would be around 50 dollars.

Box 1: Russian policy-neutral growth in 2009 under different oil price assumptions.

- Growth potential 4–5%
- Policy neutral estimate: if oil price 50 USD, 2009 growth 1%, if 90 USD, 5%
- Consistent with reported December 2008 Russian Ministry of the Economy forecast for 2009: if oil price 50 USD, growth 2.4%, if 32 USD, slightly negative

Two other ongoing changes are also of immediate importance for Russia's financial development. It has been known for some time that Russia's post-1998 sizable budget surpluses are bound to disappear within a few years. Pressures for increasing expenditures are very major, while half of revenue comes from the energy sector. With relatively low oil price in 2009 and possibly beyond, Russian federal – and consolidated – budget will be in deficit already this year. Second, the current account will also turn negative. Obviously, import growth will not hit the recent 20–30 per cent annual level, but with an expected oil price of about 50 dollars – down from 72 in 2007 and 95 in 2008 – export revenue will collapse. Money supply growth will slow down bringing at least some of inflation with it. Furthermore, as reserves decline, the Russian state will fail to have a major sovereign fund. The authorities have to find ways of boosting the net domestic assets of the central bank to prevent a major money squeeze.

This shift in the macroeconomic environment was an expected medium-term change, but now it happens faster and more dramatically.

Back in the 1990s, especially after the collapse, Russia was not a true monetary economy. The share of barter in industrial turnover peaked at

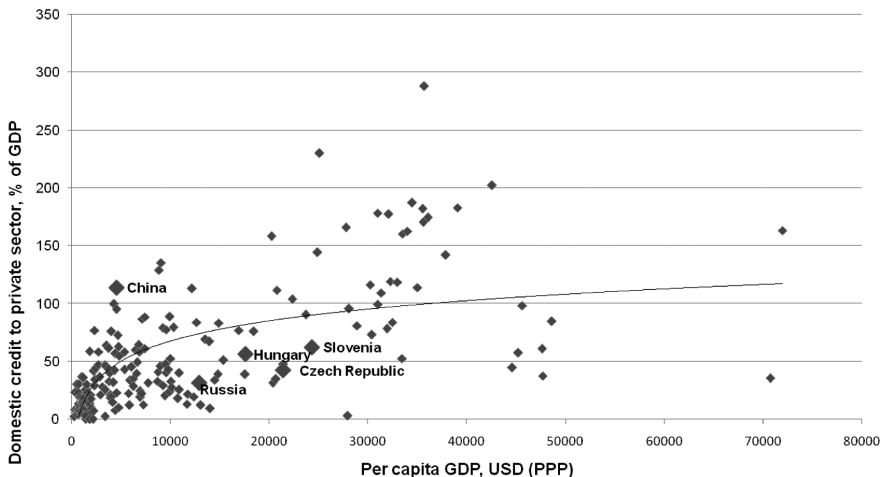
61 per cent. Russia has monetized since, with money and financial aggregates increasing by up to several tens of per cent annually. Still, the financial system remains underdeveloped.

First, Russia has a bank-centered financial system. This is not primarily due to design. Both mass privatization, attempted pension reform and more recently the so-called people's shares were meant to create a widely-spread equity ownership and well-functioning markets. For different reasons, this has failed. Only a small fraction of households own equity, traded companies are few, turnover is dominated by foreign entities trading a small number of mostly resource-based companies, and the current crisis has dealt a heavy blow. There is no market for government bonds, and little for company and financial institution debt papers, though that started to change in recent years.

This is primarily due to a simple fact: as a rule big companies have relied on foreign markets for their financial needs. While public foreign debt has been almost abolished, non-state debt of companies and financial institutions has increased fast. Its level at some 35 per cent in end-2007 however remains low in international comparison. By end-2008 that share has probably declined slightly. The share of Russia in IPO's was in 2006 just 6 per cent, but it increased to 38 per cent in 2007. Still, IPO's have usually taken place in London. At least as long as the resource boom continued, key Russian companies had good access to markets. Russia was in 2007 the biggest emitter source country in London.

Therefore, the following discussion focuses on the Russian banking system.

Figure 7: The relative size of the Russian banking sector



Second, the banking sector remains small. True enough, bank assets grew by 44 per cent annually both in 2006 and 2007, continuing an existing trend. In end-2007, the ratio of bank assets to GDP reached 61 per cent. This remained low in international comparison.

Further, low international interest rates, ample liquidity and a currency appreciating in real terms implied that Russian prime companies were borrowing in negative real terms. Some of them, like Gazprom and Rosneft, accumulated major debts. Overall, Russian debt remained until summer 2008 smaller than official reserves. There is a major refinancing need in 2009. The current Central Bank figure is USD 117bn, while other estimates put it at some USD 130–140bn.

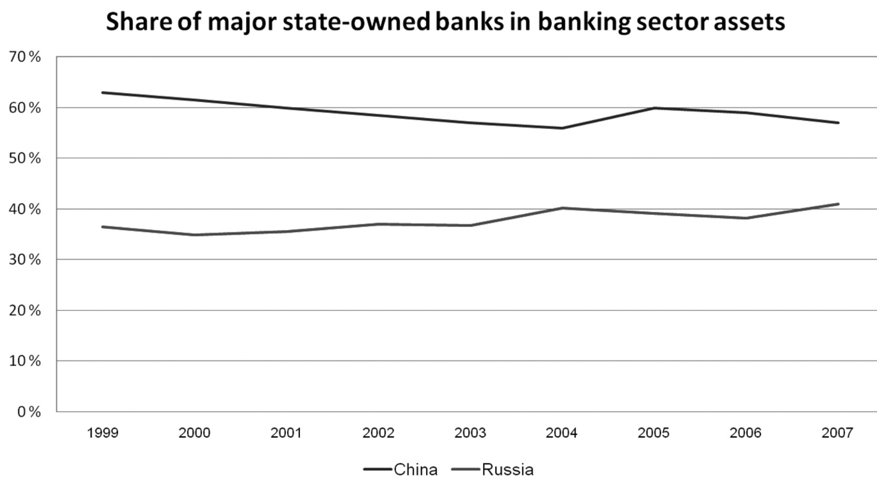
The role of foreign-owned banks – about a fifth of all assets – is modest compared with Central European and many other countries. They concentrate on servicing cross-border payments and the more affluent segments of the population. Russia is geographically huge with a very unevenly spread population. Most of the banking business – 80 per cent of corporate business and two thirds of retail business - takes place in just 15 of the 89 regions. Sberbank, the state-dominated savings bank, remains the only bank with a true nation-wide network of offices. As its share of household saving remains high, trying to compete with it in volumes would be prohibitively costly. If the Russian big business has outsourced its financial services, the home market is serviced by domestic banks. The fundamental domestic problem in Russian banking is that as long as this situation remains, the domestic banking sector will remain small and lacking in major resources. The deposit base is simply too small. Due to economies in scale in banking it will also remain inefficient.

Russia thus has a dual economy. The export-revenue earning sector of oil, gas and metals is an integrated part of the world economy. It is serviced by the global financial system. The rest of the economy, maintaining a huge majority of jobs, is almost completely dependent on the domestic banking sector. With a narrow deposit base, it is unable to finance any major investment-based growth in the domestic part of the economy.

Third, the banking system is highly fragmented and poorly regulated. Fragmentation as such contributes to difficulties in supervision. It therefore also adds to a lack of trust, and thus impedes interbank markets. Progress has been made in curbing directly criminal activities, but as the number of institutions called banks still tops 1100–1114 at end-November 2008 to be exact, true

prudential supervision remains difficult. This is also true of much needed bank consolidation. Even a small takeover is such a complicated and labor-intensive process stretching over many months that the number of banks will only decrease very slowly. Most banking institutions are of no macroeconomic consequence, though often even small banks have a key local role, often in a non-transparent cooperation with local political authorities and business interests. On the other hand, it takes the top 50 banks to account for 80 per cent of all banking activities. In most advanced countries fewer banks would be needed to reach that figure.

Figure 8: State ownership in Russian and Chinese banking systems



Fourth, in the beginning of September 2008 government-controlled banks had 47.8 per cent of all bank assets. This share is bound to rise further during the current crisis. Indeed, in end-November the share already seems to have reached 51 per cent. Sberbank, in particular, also dominates retail deposits as the core long-term financing source. At end-2007 the stock of household deposits was 16 per cent of GDP, almost half of that in Sberbank. Other sources of long-term bank financing, like life insurance and pension funds, are very small. Already before the crisis the state was a prominent source of long-term funding. A fifth of all real investment is budget-financed. Given that close to a half of general government revenue derives from the energy sector, basically exports, state thus acts as a bridge between the two sectors of the economy. In a way, it substitutes for a missing financial system. There has also been some diversification of the export sectors into the domestic economy: from metals to automotive making, from gas to media. But skills do not easily transit between such sectors, and the crisis will force a return to core competencies.

During the crisis the state with its accumulated funds is the source of liquidity and loanable funds. Sberbank is together with the two other main state-controlled banks (VTB and VEB) also the main channel of liquidity support and other crisis measures. Thus, the state maintains banking sector stability primarily through state banks. There have been no major bank runs or such, but the long-term implications of large – and increasing – role of the state in banking are questionable at best. The received wisdom is that a large share of state-controlled banks makes the bank sector less efficient, though Karas et al (2008) disagree in the case of Russia.

Fifth, most households are very poor, live from hand to mouth, and thus in an M1 world. An estimated 40 per cent of households do not have a banking account at all. Historically, banks only used to serve corporate clients. Retail lending is a relatively new phenomenon. In end-2007, the stock of household debt to GDP still remained less than 15 per cent. Loans are usually short-term, with an average maturity of less than a year. Proportion of mortgage loans remained low even before the crisis. Perhaps one tenth of real estate was bought using any credits, though the share has been higher in the metropolitan cities.

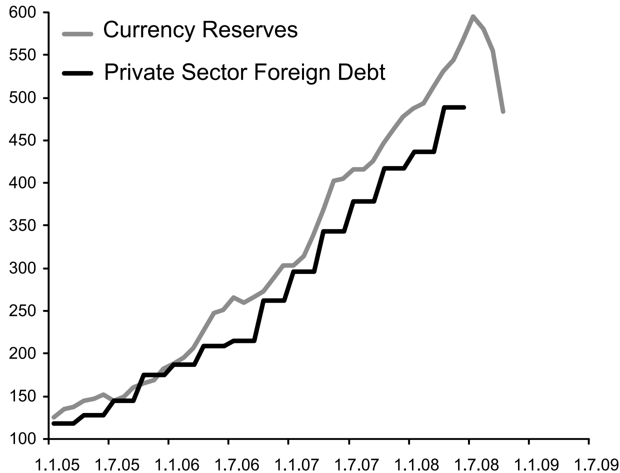
Finally, there is little reason to believe that the Russian financial system would be less corrupt than the rest of the economy. This has an impact on lending decisions. It is also plagued by lack of trust and – even in the best of times - by non-functioning inter-bank markets. State banks have a key role, as pointed out above, and many nominally private banks – some big ones and many smaller ones – are part of a complex net of private and politically controlled interests. As real interest rates have traditionally been clearly negative, demand outstrips supply, and credit rationing of some kind is inevitable.

Thus, in spite of fast growth until the crisis, the Russian banking and more generally financial system remains small, underdeveloped and in many respects peculiar. It is not well positioned to support future economic growth, especially not by channeling long-term savings into investment finance.

Accumulation of government reserves and of private and semi-private foreign debt has thus gone hand in hand. The Putin regime goal of restoring Russia's political sovereignty also by paying back foreign debt had restored Russia's creditworthiness. The state taxed away most of the export revenue windfall. Reserves were accumulated, and they were largely invested abroad. This opened the way for Russian private and semiprivate entities to start borrowing from abroad – at a negative real interest rate, remembering

ongoing ruble real appreciation. Currency reserves and private foreign debt boomed hand in hand.

Figure 9: Russia's private foreign debt and currency reserves (USD m)



As Gaddy and Ickes (2009) put it: "Russia was, in effect, paying the West to provide a service-financial intermediation on the basis of market principles rather than connections and corrupt practices – that it could not obtain at home". What this strategy – if indeed it was a conscious strategy – did not foresee, was the current crisis. The financial intermediation Russia's big companies need is no longer available abroad – but neither does it exist at home.

Russia has better bailout and stimulus potential than many other countries due to the reserves accumulated. But such reserves are not unlimited and even if the global crisis was to prove lighter than feared, with oil prices rising soon again, the basic problems of resource dependence and deterioration of human and physical capital remain. Russia would be foolish not to utilize the natural resources it has. It would be equally foolish to continue wasting them in such inefficient ways it has been doing so far. The current draft long-term energy program is the first one to emphasize energy efficiency. Even it seems to neglect new and alternative sources of energy. This is also a more general problem. Why would Russian entities invest on a major scale to developing new products, technologies and institutions with by necessity highly uncertain revenue prospects as long as Russia has its oil, gas and metals – and the rest of the world is ready to pay for them?

Politically, being sovereign in a financial sense has been a high priority. For the not too distant future, the goal has even been to have a sovereign financial system, with Moscow as one of the global financial centers and ruble as one of the reserve currencies. Foreign borrowing – the outsourcing of Russia's financial system – should be balanced by ever-increasing reserves. That strategy is now under severe risk. But there is also another threat, not related to the current situation. Russia can never live of energy alone. The Russian energy sector, narrowly defined, only provides less than 2 per cent of the nation's jobs. Like Nigeria, Mexico and Indonesia, Russia is an energy provider with a large population. The question is, are the rest of the jobs competitive? Research referred to above argues that it is not.

Therefore, though the Putin regime's aim at restoring Russia's financial sovereignty worked as long as export revenue kept increasing, it did relatively little to begin addressing the underlying long-term issues. In fact, emphasizing the issue of sovereignty is another way of looking at the Putin regime as an instance of authoritarian capitalism. A combination of authoritarian politics with the aim of a more normal – less resource-dependent – capitalism has been feasible so far. The goal of the current leadership surely is to continue aiming at that goal.

So, the Russian financial system is rather a drag than a booster for future growth. But itself, that fact is a reflection of more fundamental properties of the current regime.

This leaves the third one of our initial questions: could Russia become a regional financial center? There are four major financial centers globally, New York, London, Tokyo and perhaps Hong Kong. They all basically have an Anglo-Saxon legal system, sometimes imported through occupation or colonial power. Adding new ones among this group of first-tier financial centers has proven extremely difficult. Even before the crisis, Russia was far from this league. Currently, it lags even more. If the proposals of this talk are anywhere close to the point, today's Russia is systemically closed for a development that might change this.

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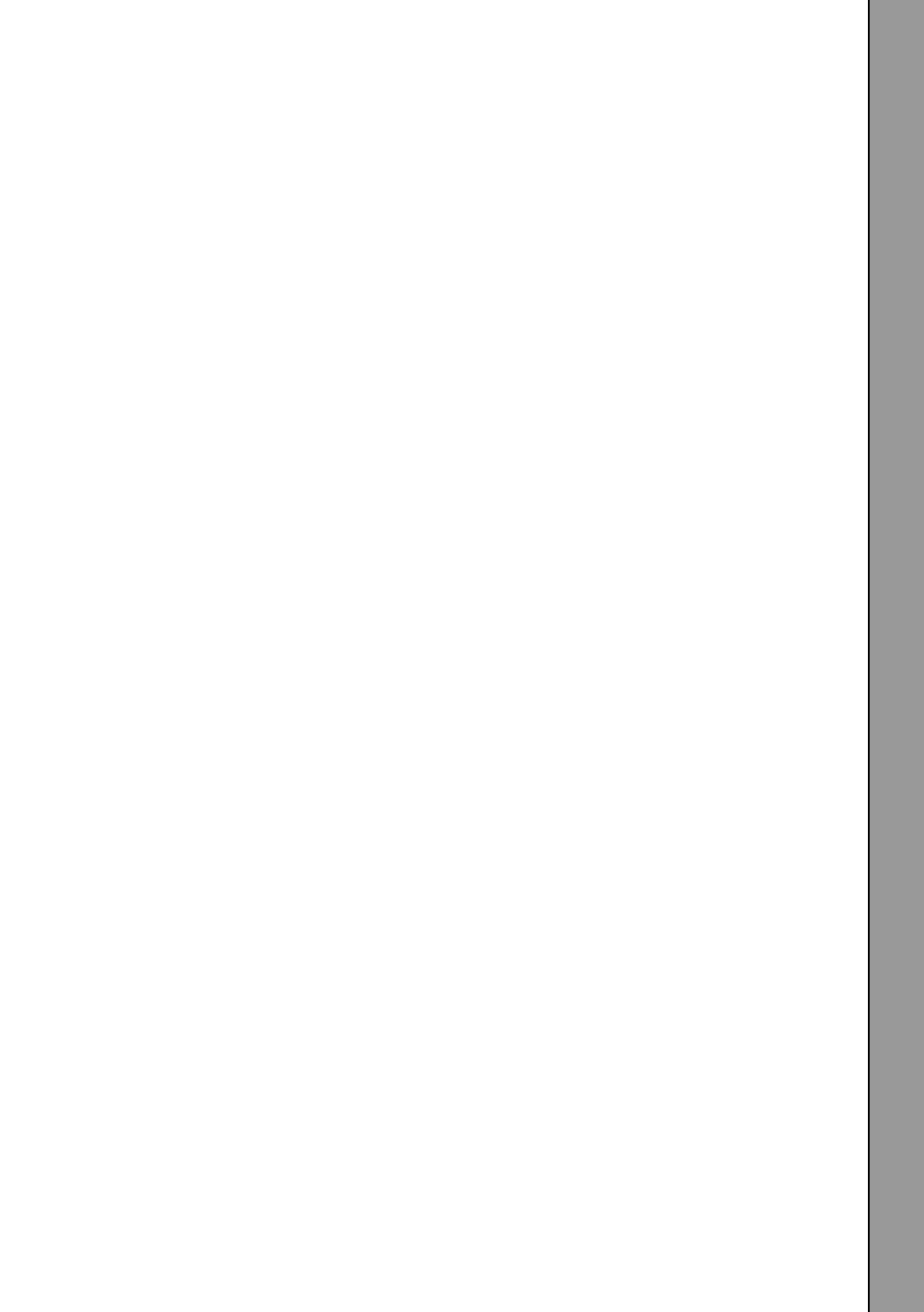

4. RUSSIAN BANKING IN RECENT YEARS: GAINING DEPTH IN A FRAGILE ENVIRONMENT

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1. Abstract

This paper provides a detailed survey of Russian banking developments since the turn of the millennium, with some greater focus on the last two to three years. A brief outline summarizes the very favorable evolution of the macro-structural background, including the oil price, during almost the entire observation period, which enabled the authorities to accumulate generous foreign currency reserves. Banking development initially featured rather slow recovery from the financial crisis of 1998, coupled with sluggish reforms. This was followed by a stepped-up pace of institutional and structural adjustment in 2003–2005, which brought about major improvements of banking activities, but coincided with a home-grown banking scare. Once the latter was overcome, one could observe accelerated expansion of a very profitable, and increasingly competitive, if not yet fully transparent sector. Given relatively low FDI, swift lending growth was increasingly financed by debt-creating capital inflows. Since August 2007, the above expansion has come under pressure from the U.S. financial crisis and the global turmoil which have, moreover, taken a sharp turn for the worse in September 2008. Repercussions for Russia include accelerated capital outflows and a drastic tightening of the liquidity conditions for banks, to which the authorities responded with a generous package of liquidity-boosting measures. A substantial decline of the oil price altered fundamentals

of the Russian economy. The ruble came under heavy pressure, triggering re-dollarization tendencies and accelerated withdrawals from bank accounts, to which the CBR reacted by launching a strategy of controlled devaluation. Whether a hard landing of the sector can be avoided, largely depends on the depth of the imminent world recession and the calibration of the still sizable anti-crisis instruments at the disposal of the authorities.

2. Introduction

Russia is by far the largest market in Central and Eastern Europe and has been growing dynamically for a decade. While banks are the country's dominant institutions of financial intermediation and have recently strengthened their roles, the banking sector is still relatively small compared to the banking sectors of other transition economies, particularly those of new EU member countries. Dynamism and ample catching-up potential combine with yet limited presence of foreign strategic investors to make Russia a major focus of interest for years to come – notwithstanding the current financial crisis. This paper proposes to give an analytical overview of banking sector development in Russia in the last six to seven years. Topics covered comprise: the evolution of legal and regulatory foundations, banking supervision, banks' major sources of assets, liabilities, earnings and related changes, bank restructuring, the role of foreign banks and FDI, credit growth, risks and reactions, vulnerabilities, government assistance programs.

This study is organized along the following lines: Chapter 2 provides a brief outline of the development of the macro-structural background in the observation period (2002 to early 2009). Chapter 3 focuses on banking development and reforms: the initially rather slow recovery and restructuring after the financial crisis of 1998 is dealt with; this is followed by a stepped-up pace of institutional reforms in 2003–2005, which bring about major improvements for banking activities and supervisory practices, but coincide with a homegrown banking scare; once this is overcome, we see accelerated expansion, which, however, has most recently given way to the impact of the global financial turmoil and crisis (since the summer and fall of 2007, and most particularly since September 2008). These newest developments are analyzed in somewhat greater detail. Chapter 4 wraps up the study with a summary of the previous chapters and a risk-oriented assessment.

3. Macroeconomic and structural background

A very modest level of departure after the crisis-prone 1990s, strongly rising oil and raw material prices since 1999 (until most recently), therefore major improvements in Russia's terms of trade over the last ten years, as well as prudent macroeconomic policies and some successful institutional and structural reforms allowed Russian economic expansion to take off at the turn of the millennium. As a result, during the decade from 1999 to 2008, the country has achieved an average annual GDP growth rate of almost 7%.[1] While economic expansion was originally driven by net exports, the momentum gradually moved to domestic demand, where private consumption took over the lead, before capital formation gained prominence recently. Both have been buoyed by a credit boom. Meanwhile, surging domestic demand increasingly absorbed accelerating imports, thus producing a rapid decline of net exports. The very high Russian current account surplus, which topped 11% of GDP in 2005, shrank to about 6% in 2008, and may dry up soon. Net FDI inflows have been positive but low (1% of GDP in 2007) (Table 1).

Negative net export dynamics and current account shrinkage were favored by the long lasting real appreciation of the ruble owing to strong inflows of forex proceeds in the context of an exchange rate policy aiming to keep the ruble stable vis-à-vis a currency basket of US dollar and euro. The Central Bank of Russia (CBR, Tsentralny bank Rossiskoy Federatsii, Bank Rossii) had been steadily accumulating foreign currency reserves, which attained EUR 397 billion (USD 598 billion) in early August 2008, before declining to EUR 300 billion (USD 384 billion) in early February 2009 under the impact of the global crisis. As of early 2009, Russia's forex reserves remain the third-largest in absolute terms, and the highest in per capita terms in the world. While the policy orientation of holding the ruble steady was aimed at protecting the competitiveness of Russia's non-resource tradable sector, the strong liquidity inflows pushed up inflation: With the exception of 2006, end-year inflation has remained in double digits in recent years. This has happened notwithstanding a tight fiscal stance delivering a string of budget surpluses since 2000 and providing for the sterilization of considerable amounts of revenue in the Stabilization Fund (which exceeded EUR 100 billion in February 2008). A tightening labor market and upward pressures on

[1] In 2008, however, Russian economic growth is estimated to have dipped to 5.6%.

wages drove up unit labor costs, which canceled out some of the exchange rate policy achievements and contributed to deteriorating external accounts.

In 2006 and 2007, capital inflows gathered momentum. Whereas the country had experienced net capital outflows until 2004, the improved macroeconomic situation, strong domestic demand and the granting of investment grade status to Russia facilitated efforts to import capital in order to finance investment projects or grant loans. To some degree, increased foreign borrowing was also prompted by speculative expectations of future appreciation of the ruble, following liberalization of the capital account in mid-2006. Net capital imports, which came to EUR 34 billion in 2006 and to EUR 59 billion in 2007, mostly consisted of credits, bonds and portfolio equity; banks carried out more than half of the capital imports, corporations accounted for most of the rest. In both cases, state-owned entities featured prominently among the major players in this field.

In the wake of the U.S. subprime crisis and the ensuing global financial turmoil (outbreak in August 2007), capital inflows to Russia became much more volatile, and banks have been particularly affected. In the first half of 2008, net capital inflows sharply declined to EUR 8 billion (from EUR 52 billion in the first half of the previous year), and they turned negative in the third quarter. Staggering local and global food and energy price rises, strong wage adjustments, some fiscal relaxation in connection with the elections of 2007–2008, as well as possible overheating pressures contributed to driving Russian CPI inflation to a new record of 15.1% in June 2008 (year--on-year). Declining inflows of export proceeds on the heels of the sharp drop of the oil price as well as the sharp reversal of capital flows in the fall of 2008 contributed to the slight decline of inflation by December 2008 to 13.3% (Table 1). The dramatic worsening of the U.S. and global financial crisis in September 2008 had substantial repercussions on Russian financial markets, triggered skyrocketing capital outflows, put strong pressure on the ruble, and increased uncertainty (see below).

Overall, since the turn of the millennium, Russian economic development has been bolstered by the political stability of the Putin era, and by a host of reforms, incl. tax, budget, labor market, energy, pension, land, infrastructural, and banking reforms. Growth could probably have been even more impressive, though, if the rule of law, including property, contract and creditor rights, had been more reliably established. Corruption remains rampant and contributes to weakening the business climate. The public sector still accounts for over one third of GDP and the state has strengthened its presence in recent years in a number of “strategic” sectors, including oil, natural resources, defense industries, transportation and banking.

Table 1

Macroeconomic, monetary and financial indicators for Russia (2002–2008)

	2002	2003	2004	2005	2006	2007	2008*
GDP growth (real, %)	4.7	7.3	7.2	6.4	7.4	8.1	5.6
CPI inflation (year-end, %)	15.1	12.0	11.7	10.9	9.0	11.9	13.3
Exchange rate (annual average, RUB/USD)	31.35	30.69	28.81	28.3	27.34	25.58	24.81
Exchange rate (annual average, RUB/EUR)	29.65	34.69	35.81	35.22	34.08	35.01	36.41
Refinancing rate (year-end, %)	21	16	13	12	11	10	13
Broad money (M2, year-end, growth in %)	32.4	50.5	35.8	36.8	48.8	47.5	1.7
Broad money (M2/GDP in %, year-end)	19.7	24.3	26.0	27.9	33.8	40.2	.
Budget balance (general government, % of GDP)	0.9	1.3	4.5	8.1	8.4	6.0	10.6 (Jan-Jun)
Current account balance (% of GDP)	8.4	8.2	10.1	11.1	9.8	6.1	5.9
Net private capital inflows (% of GDP) [1]	-2.3	-0.4	-1.5	0.1	4.3	6.3	-7.8
- of which FDI (% of GDP)	-0.1	-0.1	0.3	0.1	0.7	1.0	1.4 (Jan-Jun)
- of which bank-related (% of GDP)	0.7	2.4	0.6	0.8	2.8	3.6	-3.4
Gross external debt (year-end, % of GDP)	44.1	43.1	36.1	33.7	31.6	35.7	32.7 (Sept)
- of which: private debt (% of GDP) [2]	13.9	18.5	18.3	22.9	26.6	32.2	30.1 (Sept)
- of which: bank debt (% of GDP)	4.1	5.8	5.5	6.6	10.3	12.7	12.0 (Sept)
Net international investment position of banking sector (% of GDP)	1.0	-1.4	-1.9	-2.7	-6.0	-9.0	-6.0 (Sept)
Gross forex reserves of CBR (year-end, % of GDP)	13.8	17.8	21.0	23.8	30.9	36.9	25.5

* preliminary data or estimates

[1] minus ("-") corresponds to a net outflow

[2] non-state sector (incl. banks)

Source: CBR, wiiw

4. Banking development and reforms

4.1. The shadow of 1998: "growing out" of the Russian crisis in the early years of the new millennium

Prior to the Russian financial crisis of August 1998, the country's banking system was very weak, operated in a difficult environment plagued by distorted incentives and was largely incapable of carrying out its basic function: market-oriented intermediation between savers and investors in the real sector. In mid-1998, total assets of the banking sector were slightly below 40% of GDP, and domestic credit to enterprises came to 13% of GDP. The crisis struck the country's banks through the state's default on its internal debt (suspension of service on GKOs/ Gosudarstvennye kratkosrochnye obiazatelstva – state treasury bills) and the sharp devaluation of the ruble. Thus, credit institutions' claims on government, which had amounted to over a third of their assets in mid-1998, were all but wiped out, and banks' foreign debt, which had come to a about fifth of their total liabilities, was strongly inflated. Non-residents, which had also intensively participated in the heydays of the GKO market, found themselves among the victims of the August crisis (Barisitz 2007a, p. 129). Russia's economy contracted by over 5% in 1998, before recovering in 1999.

The authorities did not make use of the opportunity for an in-depth clean-up or structural/ institutional overhaul afforded by the crisis. The Central Bank of Russia did restore the payment system and operative capacities of the sector in a relatively short time by relaxing prudential regulations, by partly accepting GKOs at nominal value as reimbursement of loans despite the fact that GKOs had been frozen, and by providing liquidity injections to a number of distressed banks, first of all to Sberbank (the large state-owned savings bank). Moreover, to give banks some respite to cope with effects of the devaluation, the authorities declared a 90 day moratorium on private payments on obligations to foreigners. The CBR withdrew a number of licenses and from mid-1998 to end-1999 the total number of banks declined by about 250, but there were still about 1350 credit institutions left, most of which remained very small and undercapitalized. Altogether, according to IMF estimates, the direct fiscal cost of the Russian financial crisis was minimal, compared to other crisis countries, but indirect effects, via disruptions to the system, exchange and interest rate volatility and loss of confidence were significant (IMF 2003, p. 22). Repercussions for the real sector would have

probably been more serious, had financial intermediation been deeper at the time in Russia.

Starting in 1999, the confluence of a number of favorable macroeconomic and political factors (significant easing of monetary conditions through sharp devaluation that boosted competitiveness of domestic manufacturing and kick-started import substitution, subsequent recovery and strong rise of oil and raw material prices, prudent budgetary policies, some initial structural reforms, particularly tax reforms, political stability gained and retained under the Putin administration) triggered an impressive Russian recovery, which enabled a new beginning for banks, although banks initially hardly contributed anything to the recovery. Rising earnings and wealth of raw material extractors, exporters and linked industries attracted banks and provided a new financial base for the business. This was later complemented by the steady and robust recovery of wages and salaries and pronounced adjustments of pensions.

After declining to 32% of GDP at end-2000, total banking assets recovered again and grew to 42% of GDP at end-2003. 2001 and 2002 appear to be the years in which the Russian banking sector regained its pre-crisis size in many respects. At end-2001 the sector regained in real terms the balance sheet total it had held in mid-1998. The same goes for banks' equity capital. Also at end-2001, according to the monetary authorities, the sector had more than offset the losses caused by the crisis and its profitability had been restored. Measured as ratios of GDP, the volumes of credits and of deposits re-attained their pre-crisis levels in 2001, respectively 2002. Looking at monetization, the ratio M2/GDP in 2001 surpassed that of 1998. Margins between average deposit and lending rates were halved, but remained relatively high (end-2003: 8.5%) (Table 3). However, most of the above data are based on official Russian accounting standards (RAS), which tend to put greater emphasis on formal reporting requirements than on material elements and economic meaning.[2] At least until recently, a not infrequent way of dressing up the books appears to have been that banks lend to their owners who then channel the funds through shell companies to "boost" banks' capital.[3]

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[2] In this respect regulators have required and banks have been used to filing numerous and frequent financial reports. Russian credit institutions typically generate more than 100 reporting forms per month, which represents an onerous workload. Reporting tends to be formalized and legalistic, and based on a quantitative rather than a qualitative approach (Trofimova et al. 2007, p. 31).

[3] This has been dubbed "roundtripping of loans to shareholders" (Odling-Smee and Thomson 2003).

While banking activity recovered, its structure changed: Loans soon reached and exceeded half of credit institutions' total assets, while claims on the government shrank to about one tenth. In contrast to the past, lending was not subsidized or directed by the authorities. Thus, one may infer that genuine financial intermediation was gathering momentum. Banks' foreign debt substantially declined as a share of total liabilities, before increasing again somewhat in 2003. While immediately after the financial crisis, the share of foreign currencies in total corporate loans had sharply risen to two thirds, the ruble quickly regained confidence and by end-2003 the above share fell back to one third.

As a consequence of the financial crisis and the initial loss of confidence, state-owned banks managed to strengthen their position; Sberbank, the country's largest credit institution, re-established its undisputed dominance in the retail deposit market. At the turn of the millennium, over three quarters of household deposits were concentrated at this credit institution, which has profited from the largest branch network in the country by far and from an implicit deposit guarantee. However, given the ensuing recovery of private banks, this share fell to less than two thirds until end-2003. Private banks were still largely attached to FPGs (finansovo-promyshlennye gruppy/ financial-industrial groups), but financial interests no longer featured as prominently in these networks, which became dominated by resource-oriented and industrial concerns.[4] In the wake of the crisis, thanks to quick recapitalizations, foreign-owned banks managed to raise their – albeit small – market share to about 11% of total banking assets. This share subsequently declined to 7% in 2003, though (Table 3). Given the challenging business climate, particularly for foreigners, as well as lingering memories of the 1998 crisis, strategic investors did not rush to Russia in a comparable manner as FDI flooded into many other transition countries' banking sectors around the turn of the millennium.

[4] This relates to the definition of a "captive bank", i.e. a subsidiary or dependent bank, a participant of a financial-industrial group, a credit institution carrying out the lion's share of its operations with the other members of that group or conducting its activities primarily in the interest of its FPG (Tsentralny bank Rossiskoy Federatsii (2007), p. 96).

Table 2: Chronology of some recent events of banking development in Russia

Year	Events
2001	*June:* amendments to Law on Banks and Banking Activity, Bank Insolvency Law and Central Bank Law ("IMF law package") enacted: prudential norms and supervision strengthened
2002	*October:* new Enterprise Bankruptcy Law enacted: transparency of bankruptcy procedures enhanced *December:* Central Bank of Russia (CBR, Bank Rossii) declares invalid 12% limit on share of foreign capital in aggregate capital of Russian banking sector
2003	*October:* Moody's grants investment grade rating to Russia *December:* **Deposit Insurance Scheme (DIS)** introduced: all banks applying for participation in scheme undergo **special CBR inspections**; initially coverage of retail deposits of up to RUB 100,000 per person, later raised to RUB 190,000 (July 2006), and RUB 400,000 (March 2007)
2004	*Beginning of year:* Russian banks required to draw up financial statements in accordance with **IAS/IFRS** – alongside RAS, yet IAS reports are not be used for regulatory purposes until a later date *April:* **radical revision of CBR Instruction no. 1 On Banks' Mandatory Norms** (Ob obiazatelnykh normativakh) enters into force: improvement in quality of CBR supervision *June:* SBS-Agro (one of former top ten banks), victim of financial crisis of 1998, finally liquidated; *Mid-year:* Temporary **banking turbulences** trigger illiquidity and insolvency of Gutabank (mid-sized credit institution) and run on Alfabank; *July:* CBR reacts to turmoil by halving reserves requirements and by supplying low-interest loan to support takeover of Gutabank by Vneshtorgbank (de-facto nationalization); parliament passes special law providing limited interim guarantee for all bank deposits of private individuals *November:* General Electric Capital acquires Delta Kredit for EUR 80 million
2005	*May:* Banca Intesa purchases 75% stake in KMB Bank (established by EBRD) for EUR 70 million *June:* Inkombank (one of former top five banks), victim of financial crisis of 1998, finally liquidated; Law on Credit Bureaux enters into force *October:* CBR announces list of 920 banks (about ¾ of total number) accounting for about 99% of all private deposits, which have passed inspections and are admitted to DIS *Late year:* **DIS starts operations**
2006	*February:* **Raiffeisen purchases Impeksbank** for EUR 460 million *July:* **CBR removes all remaining capital controls** – the ruble becomes fully convertible; **OTP takes over Investsberbank** for EUR 380 million *September:* assassination of reform-minded CBR Deputy Chairman Andrey Kozlov *November:* Nordea acquires Ogresbank for EUR 250 million Société Générale buys 20% of Rosbank (10th largest Russian bank)

2007	*Beginning of year:* Minimum capital requirement lifted to EUR 5 million *February:* **IPOs** of minority stake of **Sberbank** attracts EUR 6.7 billon *May:* IPO of approx. 20% stake of **Vneshtorgbank** yields EUR 6.1 billion; **KBC Bank acquires Absolut Bank** for EUR 760 million *From mid-August:* **U.S. subprime crisis**-**induced global financial** turmoil triggers **large capital outflows**, interbank market faces liquidity bottlenecks *Late August:* **CBR** carries out record daily repo operations, amounting to RUB 270 billion (EUR 7.7 billion), moreover it broadens list of securities that banks can use as collateral when borrowing from the monetary authority, in order to **provide liquidity** to credit institutions *October:* CBR lowers reserve requirements to support banking liquidity *December:* **Société Générale raises its stake in Rosbank** by 30% to 50% plus one share for EUR 1.2 billion
2008	*Beginning of year:* RAS move nearer to IFRS, but material differences still remain (incl. consolidation, provisioning and bad loan reporting) *Early year:* **Sharply rising inflation** prompts CBR to hike key interest rates and tighten reserve requirements while it remains induced to provide liquidity injections to support banks in difficulty: **policy dilemma** *March:* Government decides that assets of newly-found ed development institutions (Nanotechnology Fund, Housing and Municipal Infrastructure Fund) as well as unallocated budget funds, coming to up to EUR 16 billion, may to be invested in bank deposits *April–May:* unallocated budget funds of EUR 1.8 billion are auctioned to banks *August–September:* Georgian crisis, oil price dive and **drastic worsening of U.S. financial crisis trigger capital outflows, crash of Moscow stock exchange,** **severe liquidity squeeze** of Russian banks, particularly of medium- and small-sized institutions CBR reacts with substantial foreign currency interventions and liquidity infusions *Mid-September to mid-October:* **authorities** put together **strong package to provide further liquidity** and shore up markets: financial support for banks and large enterprises, sharp cut in minimum reserve requirements, 75% increase of deposit insurance limit (to RUB 700,000), tax relief for oil companies, bailout (de-facto nationalization) of three mid-sized credit institutions, etc: total estimated amount pledged/ disbursed: **ca. EUR 150 billion** *Late October:* fragile re-stabilization of situation *Since mid-November:* **repeated and accelerated widening steps of ruble's fluctuation band**, followed by immediate **weakening of ruble** (multiple incremental devaluations) despite continuing substantial CBR forex interventions as consequence of persistent downward pressure on Russian currency *Late year:* **increased deposit withdrawals** from banking sector
2009	*Late January:* after further substantial widening step, CBR declares **controlled devaluation policy concluded**, at least for the next months; monetary authority vows to defend ruble at new lower limit of corridor if necessary (ruble nominal exchange rate compared to early Aug 2008: –40% against US dollar, –20% against euro)

4.2. Major reform steps and transitory turbulences in 2003–2005

Since the turn of the millennium, efforts to improve the legal and regulatory environment for banking activity gained momentum. In 2001 and 2002, amendments to the law on banks and banking activity, to the central bank law, and to bank and enterprise insolvency laws enhanced the framework for licensing and restructuring credit institutions and for prudential supervision. Among other novelties, consolidated accounting was introduced for bank groups, bankruptcy procedures were streamlined, and rights of secured creditors were strengthened (Perret 2001, p. 44; Rucker and Crosnier 2001, p. 129). However, full and effective application required complementary advances in related reform areas.

In the face of strong vested interests, banking reform continued to encounter difficulties, but 2003 and 2004 witnessed some important and long awaited breakthroughs in terms of the upgrading of prudential supervision, the introduction of International Financial Reporting Standards (IFRS), and the creation of a general mandatory deposit insurance scheme. The Central Bank of Russia radically revised its instruction no. 1 "On banks' mandatory norms" (Ob obiazatelnykh normativakh"), which entered into force in April 2004 (Table 2). This piece of regulation had essentially remained unchanged for a decade. The new rule exemplified efforts to shift from form to substance in regulation and may bring about a real improvement in the quality of CBR supervision in that it reduces opportunities for banks to manipulate their accounts, notably with respect to the calculation of capital and loan provisioning, in order to meet prudential ratios. Retraining regulatory staff is a major challenge, since regulators' overall approach needs to undergo a fundamental adjustment from traditional bureaucratic reporting[5] to market and risk-oriented reporting (OECD 2004, p. 202–203).[6]

Also in 2004, and consistent with the above change, IFRS was introduced for credit institutions, alongside RAS. But there are a number of caveats: For the time being, IFRS is only used for informational and analytical, not

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[5] This tradition is certainly rooted to some degree in the past Soviet practice of plan fulfillment reporting and monitoring.

[6] In this important endeavor the Central Bank of Russia can enlist European support: The ECB, together with nine national central banks – including the OeNB – participated in an EU-funded Tacis project which provided training to 400 staff members of the CBR and was designed to strengthen banking supervision in Russia. The project was launched in November 2003 and lasted for 2 years. The follow-up Eurosystem-CBR program started in May 2008 and is focusing on the implementation of Basel II – which is the emphasis of the OeNB contribution - and on training for CBR internal auditors.

for regulatory purposes. Moreover, there are doubts whether International Financial Reporting Standards are being fully and correctly applied, given the reported practice of using standard RAS-IFRS "correspondence tables", which are bound to be inadequate for carrying out sound case-by-case risk evaluation.[7] Furthermore, RAS is staying in use in the rest of the economy, and for tax purposes. According to estimations, a considerable number of Russian banks would have significant trouble in immediately and exclusively applying the IFRS regime, as their assets would probably be substantially lower when adequately measured by international standards.

After long discussions and hesitations, household deposit insurance legislation was finally signed into law in December 2003. Such insurance is considered an essential step toward boosting confidence in the sector and creating a level playing field for all credit institutions (thus eliminating Sberbank's and other state-owned banks' de-facto deposit guarantee monopoly). In order to counter moral hazard inherent in the insurance scheme, the CBR limited deposit coverage to an initially low level of RUB 100,000 per private individual (corresponding to about EUR 2,840), before raising the level to RUB 190,000 (or around EUR 5,550) in July 2006, to RUB 400,000 (ca. EUR 11,300) in March 2007, and to RUB 700,000 (EUR 19,800) in October 2008 – the latest adjustment against the backdrop of the deepening global crisis. The Central Bank of Russia appears to have made access to insurance subject to stringent inspections and conditions. The latter refer i.a. to the transparency of banks' ownership structure, the quality of their assets and capital and the effectiveness of their risk management, internal corporate governance and control systems. Banks that do not meet the admission criteria are no longer allowed to accept deposits (Loehmus and Teo 2005, p. 103).

Around 1140 credit institutions applied to take part in the scheme. The central bank engaged in what was bound to be the first serious review for the overwhelming majority of Russian banks in years (Barisitz 2004, p. 147, 149). A number of structurally weak, undercapitalized banks that had previously plagued the system were eliminated. It was in this particular environment of examinations and nervousness that two smaller banks' licenses were revoked in connection with money laundering charges in May 2004. This triggered turbulences that culminated in the illiquidity/ insolvency of a medium-sized bank, Gutabank, and sizable withdrawals even from a relatively large one,

[7] However, about 200 credit institutions (accounting for some 70% of the sector's assets) are reported to having their IFRS balance sheets audited by international accounting firms, which should imply greater reliability of the results, even if the latter are usually released only once a year, and with big delays (Trofimova et al. 2007, p. 31).

Alfabank, in July 2004. Despite adequate levels of overall liquidity, the segmentation and rigidity of the interbank market exacerbated the problem.[8]

The central bank reacted by repealing the licenses of ten smaller banks, halving its reserve requirements, and supporting the takeover of Gutabank by state-owned Vneshtorgbank with a low interest-loan. Gutabank was thus effectively nationalized. In mid-July parliament passed a special law providing for a limited interim guarantee for all existing – but not for any new - bank deposits of private individuals. These measures calmed down the situation. The CBR continued screening the sector. In the two years to end-2005, the total number of credit institutions declined by about 75 to around 1250.

Interestingly, some takeovers of small and medium-sized Russian banks by foreign-owned ones initiated at the height of the mini-crisis demonstrated increasing foreign interest - and confidence - in the Russian sector.[9] After the slowdown in the summer, banking activities resumed their – fragile but swift – expansion in the fall of 2004. Another legislative step aimed at facilitating banking, the law on credit bureaux, entered into force in June 2005. Over the summer of that year, four credit bureaux were registered – incl. one affiliated to Sberbank. The law aims at reducing loan risks by creating more borrower transparency. On the heels of regulatory tightening, the Central Bank of Russia took action against 190 banks found to have artificially inflated their capital. According to the CBR, by September 2005 fictitious capital coming to almost EUR 300 million had been detected and removed from banks' balance sheets. In early October 2005 the central bank announced a list of around 920 banks (about three quarters of the total number) accounting for 99 per cent of all private deposits, which had passed the inspections and were admitted to the deposit insurance scheme. The scheme started to operate in late 2005 (Table 2).[10] While not perfect, it seems to have fulfilled its role of strengthening depositor confidence in Russian banks: While annual real growth of household deposits almost halved in the year of the mini-crisis, strong expansion resumed in 2005 and continued in the following years.

[8] In the Russian interbank market, liquidity is distributed unevenly. Only a few banks tend to act as liquidity providers and many second-tier credit institutions typically lack adequate collateral and therefore face difficulties in refinancing themselves through the market or the monetary authority. In stress situations like the one that affected several banks in the summer of 2004, liquidity can quickly dry up, forcing some players to sell their assets (Moser and Nestmann 2007, p. 12–13).

[9] General Electric Capital acquired Delta Kredit for EUR 80 million in November 2004 and Banca Intesa purchased a 75 per cent stake in KMB (founded by the EBRD) in May 2005.

[10] In the view of some observers, the fact that banks accounting for only a negligible share of deposits had been denied access may raise concern about continuing regulatory forbearance (IMF 2006, p. 22).

With hindsight, the banking scare of 2004 just appears as a “hiccup” in the financial deepening process. As a share of GDP, the balance sheet total of the banking sector slightly contracted in 2004, before resuming strong growth and coming to 45% in 2005 (Table 3). During and immediately after the mini-crisis, Sberbank managed to slow down the erosion of its share of total household deposits, but at end-2005, this share had declined to 55%. Nevertheless, with the takeover of Gutabank, state-owned credit institutions held on to their pre-eminent position in the sector. Apart from the selling off some minority public stakes in smaller banks, privatization of banks seems to have ground to a halt. After slowing in 2004, the expansion of deposits, measured as ratio to GDP, bounced back in 2005. Credits recouped their dynamics in 2006, when they reached 35% of GDP. Loans with maturity exceeding one year grew to about half of the total credit volume in 2005. Lending to households started to play an appreciable role: Its share in total lending increased from 8% in 2003 to a sixth in 2005. Related party lending reportedly declined among the largest 30 Russian credit institutions, but in mid-2005 was still estimated to account for 20-50% of the loan portfolio (Aris 2005, p. 90).

Following the mini-crisis, the share of forex deposits in total deposits slightly rose from 27% in 2004 to 28% in 2005, before resuming its downward path. The loan structure displayed a comparable development.[11] Non-performing loans are here identified as including not only problem loans and bad loans, but also doubtful loans, as measured by the Central Bank of Russia. In this sense, non-performing loans increased sharply from 9% of total credit in 2003 to 16% in 2004, before they eased to 15% in 2005 (Table 3). While the turmoil of 2004 probably played a role in the deterioration of this indicator, the above mentioned overhaul of accounting standards and of prudential supervision[12] had a major impact, reducing the comparability of respective 2004 and pre-2004 data (Trofimova et al. 2007, p. 20). Profitability has been on an increasing trend. Capital adequacy - while way above the regulatory minimum of 10% - has been declining, which is not untypical of the situation in a gathering credit boom.

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[11] The interlude of the mini-crisis thus also shows the fragility of depositor confidence in the ruble when confronted with instability.

[12] The classification criteria were changed from the previous purely formula-driven approach to a principally risk-driven approach.

Table 3 Banking sector-related indicators for Russia (2002–2008)

	2002	2003	2004	2005	2006	2007	2008 H1	2008*
Number of operating banks (of which foreign-owned, end of period)	1329 (37)	1329 (41)	1299 (42)	1253 (52)	1189 (65)	1136 (86)	1125 (..)	1108 (..)
Balance sheet total								
- annual real growth (%)[1]	14.1	20.1	14.0	23.1	32.1	28.8	16.5	22.9
- ratio to GDP (%)	38.3	42.1	41.7	44.8	51.9	61.0	61.3	67.5
Equity capital								
- ratio to GDP (%)	5.4	6.2	5.6	5.7	6.3	8.1	7.9	9.2
- share in assets (%)	14.1	14.7	13.4	12.7	12.1	13.3	12.9	13.6
Share of state-owned[2] banks (%)								
- in total banking sector assets	.	.	.	40.7	37.8	39.2	.	.
- in total banking sector capital	.	.	.	33.9	32.4	40.8	.	.
Share of large private[2)3)] banks								
- in total banking sector assets	.	.	.	40.9	41.0	35.5	.	.
- in total banking sector capital	.	.	.	42.1	42.3	33.5	.	.
Share of foreign-owned[2] banks (%)								
- in total banking sector assets	8.1	7.4	7.6	8.3	12.1	17.2	18.6	19.1 (Sept)
- in total banking sector equity capital	.	6.6	7.8	9.2	12.7	15.7	18.4	24.8 (Sept)
Share of foreign owners in total statutory capital of the sector (%)	5.2	5.1	6.1	11.2	16.0	25.2	26.9	28.3 (Sept)
Deposit rate (average, % p.a.)	5.0	4.5	3.8	4.0	4.1	5.2	5.6	6.8 (Nov)
Lending rate (average, % p.a.)	15.7	13.0	11.4	10.7	10.4	10.8	11.3	15.0 (Nov)
Deposit volume								
- annual real growth (%)[1]	16.7	31.3	19.7	27.7	33.7	26.9	18.2	6.3
- ratio to GDP (%)	19.6	23.6	24.4	27.3	32.0	37.1	37.3	35.5
- household deposits: annual real growth (%)[1]	32.1	31.8	16.7	25.7	26.6	21.0	15.3	1.1
- share of household deposits in total deposits (%)	48.4	48.7	47.5	47.0	44.5	42.4	41.1	40.1
- share of forex deposits in total deposits (%)	.	28.9	27.2	28.1	23.4	20.9	21.8	32.7
Credit volume								
- annual real growth (%)[1]	.	.	31.1	28.7	36.3	34.9	34.5	23.2
- ratio to GDP (%)	19.8	23.0	26.2	29.5	35.2	43.3	46.1	48.0
- lending to households: annual real growth (%)[1]	.	56.2	93.7	76.9	63.6	41.0	.	19.3
- share of lending to households in total credit (%)	.	8.2	12.0	16.5	19.9	20.8	20.7	20.1
- mortgage loans: annual real growth (%)[1]	.	.	.	207.2	308.8	132.4		.
- share of mortgage loans in total credit (%)	.	.	0.4	1.0	2.9	5.1	5.6 (Mar)	.
- share of forex loans in total loans (%)		.	30.0	31.5	28.8	26.6	25.5	30.2
Non-performing loans[4] (in % of total loans)	9.9 (5.6)	9.3 (5.0)	16.0 (3.3)	15.2 (2.6)	13.0 (2.4)	11.0 (2.5)	.. (2.4)	.. 2.5 (Sept)
Loan loss reserves (in % of total loans)	6.3	5.9	4.9	4.6	4.1	3.7	3.5	4.5
Credit to deposit ratio (%)		97.5	107.4	108.1	109.9	116.7	123.5	135.4
Return on equity (ROE, %)	18.0	17.8	20.3	24.2	26.3	22.7	19.5	.
Return on assets (ROA, %)	2.6	2.6	2.9	3.2	3.3	3.0	2.9 (Mar)	.
Capital adequacy (%)	19.1	19.1	17.0	16.0	14.9	15.5	14.8	16.8
Liquidity								
- share of highly liquid assets to total assets (%)	22.3	20.6	17.1	15.2	13.6	12.1	10.7	11.5 (Sept)
- ratio of liquid assets to short-term liabilities (%)	90.6	90.4	78.0	73.8	76.8	72.9	74.6	77.2 (Sept)
EBRD index of banking sector reform	2.0	2.0	2.0	2.3	2.7	2.7	2.7	2.7

* preliminary data

1) deflated by CPI

2) share of respective owners (state or domestic private or foreigners) in statutory capital above 50%

3) Large private banks = 200 largest banks, as measured by assets, excluding state-owned and foreign-owned institutions

4) as measured by doubtful, problem and bad loans, according to CBR assessment (in parentheses: problem and bad loans)

Source: CBR, EBRD, IMF, RZB

4.3. Continuing on the catching-up lane: Impressive credit boom, but finally halted by global financial turmoil

4.3.1. The gathering credit boom (2006–2007)

Financial intermediation continued to deepen swiftly in Russia up to the fall of 2008, despite important repercussions of the U.S. subprime crisis (since the late summer of 2007), and of sharply rising inflation, which both contributed to slowing down expansion somewhat. However, expansion has been severely curtailed toward the end of 2008, under the impact of the aggravation of the U.S. and global crisis. Whereas the Russian banking sector's growth rates have not matched those of its fastest growing regional peers (incl. the Bulgarian, Kazakhstani, Latvian and Ukrainian sectors), the near doubling of the balance sheet total as a ratio of GDP in seven years to 61.0% in 2007 (Table 3) is certainly a major structural advance, while possibly avoiding undue risks of explosive growth.

Since 2005, there has been considerable progress in implementing the ambitious banking reform measures referred to in the preceding subchapter. While much remains to be done to enhance transparency in the sector, Russian banks have already become more transparent to both the regulator and outsiders, particularly when it comes to questions of beneficial ownership. There are indications that some credit institutions have made major strides in improving corporate governance, are relying much less on related-party lending, and are caring more about their own franchise value, which increases the incentives for them to behave prudently (OECD (2006), p. 62; The Banker (2008a), p. 80). Still, the assassination of the leading Russian bank regulator, Andrey Kozlov, in September 2006 in all liklihood constituted a setback for the process of banking reform.

In the last two years progress in addressing issues that require further legislative/ regulatory action somewhat slowed down. At the beginning of 2007, the minimum paid-in capital level for banks was lifted from EUR 1 million to EUR 5 million (in line with EU rules). While 43% of the total number of Russian credit institutions did not meet the new threshold at end-2006, this measure did not trigger a wave of bank closures, as the law

allows these banks to continue operating as long as their capital does not fall below their level reported on 1 January 2007. In support of the above stance, it has been repeatedly argued that many small credit institutions fulfill niche activities, sometimes in remote regions with no other bank service available, and typically demonstrate flexibility in adapting to their environment. At end-2007, 36% of all banks still had capital below EUR 5 million. At the beginning of 2008, the CBR enacted changes in Russian Accounting Standards, which eliminated some discrepancies between domestic and international bookkeeping principles[13], but material differences still remain (incl. with respect to consolidation, and problem loan reporting and provisioning) (Trofimova et al. (2007), p. 29–30) (see also Table 2).

The speed of Russian banking sector expansion reached a climax just before the impact of the U.S. subprime crisis made itself felt. Aggregate balance sheet growth (in real terms, year on year) accelerated from 32% at end-2006 and 38% at mid-2007. Lending to enterprises and particularly to households has been the driving force of this expansion. Credit to enterprises grew by almost a third, while retail credit expanded by over half in both periods. The share of lending to households in total credit rose from a sixth in 2005 to over a fifth in mid-2007. Not unlike in other transition countries, mortgage loans witnessed phenomenal growth, if from a minute base. As of end-2006, housing credits had not yet surpassed 3% of total credit. Overall lending rates and deposit rates have been on the decline, reaching about 9.2% respectively 5.1% in July 2007, but margins have remained rather high, reflecting considerable lingering risks. Banks' purchases of stocks and shares almost doubled from early 2006 to mid-2007, but from a modest point of departure (Table 5).

Rising intermediation was primarily financed by expanding corporate and household deposits. However, the speed of expansion of household deposits slowed down somewhat in 2006, because the population increasingly diversified savings into mutual funds and shares of big companies (Tsentralny bank Rossiskoy Federatsii (2007), p. 21). Against the backdrop of slowly declining inflation and continuing upward pressures on the exchange rate, ruble monetization gained further momentum and the share of domestic currency deposits in total deposits rose from 70% in 2003 to almost 80% in mid-2007. The share of long-term household deposits (exceeding one year of maturity) slightly rose to about 60% of total retail deposits at end-2006. Currency and maturity structures of loans featured quite similar evolutions (Table 4).

[13] These relate e.g to cash accounting and netting of interbranch transactions.

While relatively less important as sources of finance, credits and funds received from other banks – including foreign banks - grew most dynamically. Largely as a result of buoyant capital inflows since the second quarter of 2006, Russian credit institutions' external debt (primarily comprising syndicated loans and eurobonds) grew as a share of banks' total liabilities from about 15% at end-2004 to 22% at end-2006 (Table 4). Credit institutions turned to foreign borrowing due to the credit boom, Russia's traditionally relatively high credit/deposit ratio (110% in 2006), the fact that taking up funds abroad became cheaper thanks to the country's improved credit ratings and an abundance of liquidity on world markets, Russia's full capital account liberalization in mid-2006, and persistent nominal appreciation pressures on the ruble. During this favorable period on the world markets, a number of small and medium-sized banks also gained access to external credit.

Rising boom-triggered recourse to foreign funds has forced banks to gradually become more transparent. This also refers to the taking up of additional equity capital: Another financial source of expanding intermediation were Sberbank's and Vneshtorgbank's initial public offerings of important minority stakes. In each case, over EUR 6 billion of funds were attracted from foreign and domestic portfolio investors in the first half of 2007, which placed these IPOs among the largest share offerings anywhere in the world that year (see also Table 2). However, the state held on to majority ownership of the two institutions.

Non-performing loans as a share of total loans continued to decline from 15% at end-2005 to 13% a year later. Problem and bad loans declined from 2.6% to 2.4% of total loans. However, the share of overdue credit in booming retail credit started to increase in 2005, and reached 2.6% at end-2006 and 3.3% in mid-2007.[14] This rather unusual increase of problematic household credit during a boom gave rise to concern on the part of the CBR and the authorities. These concerns came on top of doubts that the very high lending growth rates would still allow proper evaluations of credit risks in the first place (Moser and Nestmann 2007, p. 12).

Despite relatively high default rates, the retail business remained profitable. In many cases, this appears to have been the result of banks covering losses from bad debtors by building a range of charges, fees and commissions into loan contracts (OECD 2006, p. 63). Yet, as of the 1 July 2007, credit

[14] Given that Russia has remained in the midst of a credit boom, that accounting practices and prudential data have been only slowly adjusting to modern principles, and that corporate governance has continued to be weak, above referred-to figures on non-performing and overdue credits may rather indicate a bottom limit (IMF 2007, p. 8).

institutions have been required by the CBR to declare the full real credit costs to borrowers, which has rendered abusive consumer credit practices more difficult. Overall provisions (loan-loss reserves) continued to steadily decline. Boosted by wide interest rate margins and high credit growth, profitability continued its upward trend with return on equity (ROE) reaching 26.3% and return on assets (ROA) coming to 3.3% of GDP at end-2006. Capital adequacy further contracted slightly to 14.9% (Table 3).

Attracted by the impressive economic expansion, the credit boom and high profitability, inward banking FDI started to get off the ground. In February 2006, a long-awaited larger foreign investment occurred in the sector: Raiffeisen purchased the privately-owned, middle-sized and retail-oriented Impeksbank (ranked 17th as measured by assets at the time) for about EUR 460 million. In July 2006, Hungarian OTP Bank bought midsize Investsberbank for EUR 380 million. In November of the same year, Nordea paid EUR 250 million for Ogresbank (ranked among the top 50 Russian banks). Also in 2006, Société Générale acquired a 20% stake (with an option to buy another 30% at a later point) in Rosbank, Russia's tenth-largest credit institution at the time. The share of majority-foreign owned credit institutions in total banking sector assets rose from 8% at end-2005 to 12% a year later. The share of foreign owners in total statutory capital increased to 16% in this period. While foreign investors used to focus on servicing international enterprises and big domestic exporters and manufacturers, they have recently ventured into retail banking and even SME lending, where their increased presence has impacted competition.

Table 4 Russian commercial banks: structure of liabilities 2002–2007

	31 Dec 2002 (RUB bn)	Share in %	% of GDP	31 Dec 2004 (RUB bn)	Share in %	% of GDP	31 Dec 2005 (RUB bn)	Share in %	% of GDP	31 Dec 2006 (RUB bn)	real gr. (% yoy)	Share in %	% of GDP	30 Jun 2007 (RUB bn)	real gr. (% yoy)	Share in %	31 Dec 2007 (RUB bn)	real gr. (% yoy)	Share in %	% of GDP
Customers' funds[1]	2152.2	51.9	19.9	4012.8	56.2	23.5	5913.4	61.0	27.3	8613.1	33.6	61.7	32.0	10330.3	36.9	60.1	12232.2	26.9	60.7	37.1
- ruble-denominated	.	.	.	2920.8	40.9	17.1	.	.	.	6600.0	.	47.3	24.6	8222.0	.	47.8	9674.5	31.0	48.1	29.3
- foreign currency-denominated	.	.	.	1092.0	15.3	6.4	.	.	.	2013.0	.	14.4	7.5	2108.3	.	12.3	2557.7	13.5	12.7	7.8
- corporate deposits, funds in current and other accounts	1023.5	24.7	9.4	1867.4	26.2	11.0	3111.9	32.1	14.4	4751.8	40.1	34.0	17.7	5032.7	41.2	29.3	7014.9	31.9	34.9	21.3
- household deposits	1060.7	25.6	9.8	1980.8	27.7	11.6	2761.2	28.5	12.8	3809.7	26.6	27.3	14.2	4348.1	28.1	25.3	5159.2	21.0	25.6	15.6
- of which: short-term (up to one year maturity)	.	.	.	846.2	11.9	5.0	.	.	.	1495.2	.	10.7	5.6	1611.1	.	9.4	1939.9	17.0	9.6	5.9
- of which: long-term (more than one year maturity)	.	.	.	1131.0	15.8	6.6	.	.	.	2314.6	.	16.6	8.6	2737.0	.	15.9	3219.3	24.3	16.0	9.8
Loans and other funds received from other banks	315.4	7.6	2.9	737.1	10.3	4.3	1086.4	11.2	5.0	1730.5	46.1	12.4	6.4	2103.9	51.5	12.2	2807.4	45.0	13.9	8.5
Promissory notes (vekselia) and bank acceptances	372.4	9.0	3.4	506.2	7.1	3.0	614.5	6.3	2.8	790.5	18.0	5.7	2.9	717.6	0.9	4.2	822.2	-7.1	4.1	2.5
Provisions for possible losses	168.3	4.1	1.6	257.9	3.6	1.5	343.0	3.5	1.6	452.4	21.0	3.2	1.7	525.0	27.0	3.1	586.3	15.8	2.9	1.8
Other liabilities	484.5	11.7	4.5	580.5	8.6	3.4	418.7	4.3	1.9	594.0	.	4.3	2.2	1108.8	.	6.4	867.8	.	4.3	2.6
Bank funds and profits	652.5	15.7	6.0	1006.1	14.1	5.9	1320.2	13.6	6.1	1783.0	23.9	12.8	6.6	2416.4	50.5	14.0	2809.2	40.8	14.0	8.5
Total liabilities	4145.3	100.0	38.3	7100.6	100.0	41.7	9696.2	100.0	44.8	13963.5	32.1	100.0	51.9	17202.0	38.1	100	20125.1	28.8	100.0	61.0
Memorandum item:																				
Share of external debt in total bank liabilities[2] (%)		12.9			14.8							21.9			23.2					

[1] Excluding budgetary funds

[2] Excluding bank funds and profits

Table 5 Russian commercial banks: structure of assets 2002–2007

	31 Dec 2002 (RUB bn)	Share in %	% of GDP	31 Dec 2004 (RUB bn)	Share in %	% of GDP	31 Dec 2005 (RUB bn)	Share in %	% of GDP	31 Dec 2006 (RUB bn)	real gr. (% yoy)	Share in %	% of GDP	30 Jun 2007 (RUB bn)	real gr. (% yoy)	Share in %	31 Dec 2007 (RUB bn)	real gr. (% yoy)	Share in %	% of GDP
Cash, precious metals and gemstones	91.2	2.2	0.8	196.3	2.8	1.2	263.4	2.7	1.2	368.5	28.3	2.6	1.4	306.1	21.3	1.8	501.7	21.7	2.5	1.5
Accounts with the CBR	416.8	10.1	3.8	695.5	9.8	4.1	684.1	7.1	3.2	955.6	28.2	6.8	3.6	1532.9	92.5	8.9	1294.7	21.1	6.4	3.9
- required reserves transferred to the CBR	200.7	4.8	1.9	121.6	1.7	0.7	161.3	1.7	0.7	220.9	25.6	1.6	0.8	244.7	18.6	1.4	221.6	-10.4	1.1	0.7
Securities acquired by banks	779.9	18.8	7.2	1086.9	15.3	6.4	1539.4	15.9	7.1	1961.4	16.9	14.0	7.3	2725.9	30.7	15.8	2554.7	16.4	12.7	7.7
- debt obligations (bonds)	502.6	12.1	4.6	752.6	10.6	4.4	1036.6	10.7	4.8	1341.2	18.7	9.6	5.0	1824.0	27.6	10.6	1674.0	11.5	8.3	5.1
- of which: Russian government bonds	412.8	10.0	3.8	435.6	6.1	2.6	492.0	5.1	2.3	537.2	0.2	3.8	2.0	615.6	8.0	3.6	580.3	-3.5	2.9	1.8
- stocks and shares	68.7	1.7	0.6	140.9	2.0	0.8	292.8	3.0	1.4	391.0	22.5	2.8	1.5	645.1	51.9	3.7	629.6	43.9	3.1	1.9
Credit claims	2148.8	51.8	19.8	4463.8	62.9	26.2	6387.1	65.9	29.5	9466.2	36.0	67.8	35.2	11217.2	37.0	65.2	14288.6	34.9	71.0	43.3
- on enterprises	1654.0	40.0	15.3	3347.8	47.1	19.2	4397.1	45.3	20.3	6147.8	28.3	44.0	22.9	7138.5	33.0	41.5	9316.0	35.4	46.3	28.2
- on households	.	.	.	538.2	7.5	3.2	1055.8	10.9	4.9	1882.7	63.6	13.5	7.0	.	.	.	2971.1	41.0	14.8	9.0
- on other banks	291.4	7.0	2.7	425.8	6.0	2.5	668.0	6.9	3.1	1035.6	42.2	7.4	3.9	1117.1	30.6	6.5	1418.1	22.4	7.0	4.3
- ruble-denominated	.	.	.	3124.7	44.0	18.3	4375.2	45.1	20.2	6739.9	41.3	48.3	25.1	8263.9	.	48.0	10487.5	39.1	52.1	31.8
- foreign currency-denominated	.	.	.	1339.1	18.9	7.9	2011.9	20.7	9.3	2726.3	24.3	19.5	10.1	2953.2	.	17.2	3800.8	24.5	18.9	11.5
- loans with maturity over one year	756.4	18.2	7.0	1937.3	27.2	11.4	3174.4	32.7	14.7	5031.8	46.4	36.0	18.7	.	.	.	.	.	.	.
Fixed assets and inventories	157.2	3.8	1.5	222.8	3.1	1.3	233.4	2.4	1.1	334.9	31.6	2.4	1.2	478.6	23.3	2.8	434.8	16.0	2.2	1.3
Other assets	551.4	13.3	5.1	435.3	6.1	2.6	588.8	6.1	2.7	876.9	.	6.3	3.3	941.3	.	5.5	1046.6	.	.	.
Total assets	4145.3	100.0	38.3	7100.6	100.0	41.7	9696.2	100.0	44.8	13963.5	32.1	100.0	51.9	17202.0	38.1	100.0	20125.1	28.8	100.0	61.0
Memorandum item:																				
Share of loans with maturity over one year in total loans (%)		35.2			43.4							53.3								

Source of tables 4 and 5: CBR

4.3.2. Impact of the global financial turmoil and high inflation (2007–2008)

4.3.2.1. The U.S. subprime crisis (from August 2007)

Capital inflows into Russia became much more volatile since the summer of 2007. This reflects the impact of the global financial turmoil, which was triggered by the U.S. subprime crisis of August 2007 and so far culminated in the major U.S. and world financial crisis that broke out in September 2008. The third quarter of 2007 featured a net overall and banking capital outflow from Russia, which reversed in the fourth quarter of 2007, turned negative anew in the first quarter of 2008, and became positive once again in the second quarter of 2008, to be followed by another reversal in the summer of 2008.

Global markets' change in risk appetite largely affected medium and smaller-sized Russian banks, which had focused on financing consumer lending and were either cut off from foreign finance or confronted with much more onerous conditions. Net outflows also reflected Russian banks reducing their borrowing on international markets in response to higher interest rates. Intermittent interruptions of capital inflows tightened refinancing conditions and pushed up interest rate levels on the domestic interbank loan market, which took up some of the strain from the contraction of inflows. Overnight lending rates, that before the outbreak of the 2007 crisis had typically been running in the range of 3–5%, rose to 5–8% in August 2007 and the following months. In late August 2007, the Central Bank of Russia conducted the first ruble supporting intervention on the forex market since 2002.

Moreover, Russian corporations, which had been borrowing heavily abroad in recent years and had accounted for the bulk of the rest of the capital inflows (besides banks), encountered difficulties in funding their activities. Interbank interest rates only hesitantly declined again in late 2007 and early 2008.[15] No doubt Russia was more exposed to the 2007 (subprime) crisis than most other Central and Eastern European economies, including neighboring Ukraine, whose banking sectors already featured larger shares of FDI. In these latter countries, foreign parent banks tended to keep open vital financing channels to their subsidiaries, therefore dampening the liquidity squeeze. Moreover, due to its comparatively high loan/ deposit ratio, the Russian banking sector

[15] In any case, real interest rates have remained negative, particularly against the background of rising inflation (see below).

has been more sensitive to changes in the conditions of external funding than most other countries of the region (Raiffeisen Research 2008a, p. 48).

The Central Bank of Russia contributed to calming down the situation by quickly and repeatedly supplying liquidity. This was carried out through repo operations, through cutting reserve requirements and through broadening the list of securities that credit institutions can use as collateral when borrowing from the central bank. Liquidity injections in overnight repo operations peaked at EUR 7–8 billion in August-September 2007. Altogether, the CBR is reported to have injected some EUR 80 billion of liquidity in the eight weeks from mid-August to mid-October 2007, while it hadn't previously intervened in the market since the beginning of that year (Daucé and Walter 2008, p. 22). An end-2007 surge in government spending also helped ease liquidity (IMF 2008a, p. 11).

However, the sharp rise of inflation since the fall of 2007 complicated CBR banking stabilization policy. Consumer price inflation rose from 9.0% at end-2006 to 11.9% at end-2007 and above 15% in mid-2008 (year on year), the highest level since 2005. The monetary authority became confronted with a serious dilemma of opposing goals of monetary policy and of banking soundness. This is exemplified by unsuccessful price controls (October 2007–April 2008), interest rate hikes (February, April, June and July 2008) and increases of reserve requirements (March, July and early September 2008) to combat accelerating or high-level inflation, and on the other hand by additional liquidity infusions (February and March 2008) and other measures, incl. auctions to place surplus budget funds as bank deposits to support credit institutions in need of cash (April and May 2008) (Table 2).

Whatever the result of the above steps, the liquidity squeeze appeared to have loosened in the spring and the early summer of 2008, before abruptly reaching new unprecedented heights in the crisis that started in August. Russia's gross external debt rose to USD 527 billion (EUR 340 billon) at end-June 2008. 37% of this debt was bank debt, 56% were private non-bank (mostly enterprise) liabilities. While in July 2008, overnight interbank rates reportedly reached the lower end of the usual trading range, they sharply rose again during the armed clashes with Georgia in early August. The Georgian conflict and concern over a possible worsening of political relations with the West triggered new capital outflows from Russia to which the CBR responded by intervening in the forex market in defense of the ruble and by increasing the amount of credit available to the banking sector (Frankfurter Allgemeine Zeitung 2008, Financial Times 2008a, BOFIT 2008c).

4.3.2.2. The aggravation of the U.S. and global financial crisis (from September 2008)

By early September, the fallout from the Georgian crisis seemed to have been somewhat eclipsed by the effects of the sharp decline of the oil price (from a peak of USD 140/barrel in July to USD 90/barrel in mid-September) and of the drastic worsening of the U.S. and global crisis, which triggered a “flight to quality”, incl. a “re-pricing” of emerging market risks (Sapir 2008b, p. 42). Capital outflows from Russia further accelerated, the Moscow stock exchange plunged deeply (which prompted the authorities to suspend trade on repeated occasions, sometimes for more than a day), the liquidity situation of Russian banks deteriorated and exerted pressure on their capitalization. This goes particularly for medium and smaller-sized institutions, which often lack necessary collateral.

From mid-August to mid-September, capital outflows were estimated at EUR 24 billion (IMF Global Markets Monitor 2008a). In the same period, the RTS index lost close to 40% (over 50% since its peak in mid-May 2008). Overnight interbank rates sharply rose to 8% at the end of August and above 10% in mid-September. This obviously points to a high degree of vulnerability of the Russian financial and corporate system due to its dependence on debt-creating capital inflows and its practices of raising cash by pledging corporate shares (repo-stock-loans) and of extensive leveraging. In this sense, the connection of the banking sector with the stock market (respectively its foreign financing) reflects a substantial degree of exposure, which bore incisive consequences (margin calls and emergency sales) once the Moscow stock exchange collapsed.

As of September 2008, there could be no doubt that banking stability had - in a dramatic manner - reclaimed precedence over combating inflation in the CBR’s list of policy priorities. The monetary authority continued to intervene intensively in defense of the ruble, with the result that Russian foreign exchange reserves (incl. gold) that had almost reached USD 600 billion in early August fell back to USD 560 billion by mid-September. Expressed in euros, however, reserves fluctuated much less and remained more or less stable at above EUR 390 billion, owing to exchange rate movements during these weeks.

In the wake of the bankruptcy of the large American investment bank Lehman Brothers and the shock waves it had given rise to, the authorities in the second half of September and the first half of October issued a number of strong measures to inject liquidity and shore up financial markets. Major elements include (Neue Zürcher Zeitung 2008a, IMF Global Markets Monitor 2008b, – 2008c):

- a sharp cut (by over 4 percentage points) of reserve requirements (bringing them back to their level of January-February 2008 and freeing up an estimated EUR 8 billion of liquidity for banks),
- an upward adjustment of the ceiling of daily repo auctions (to a maximum volume of EUR 27 billion),
- financial support (via deposits, credits and purchases of shares etc.) for dozens of large and medium-sized banks (total assistance offered: above EUR 50 billion; targeted institutions were also expected/ required to on-lend money to smaller illiquid banks),
- financial support for large quoted enterprises (EUR 14 billion; incl. government plans to buy up shares on the stock market and to re-sell them again when the market improves),
- further financial assistance (EUR 13 billion) from the National Welfare Fund through the state development institution Vneshekonombank (VEB) to buttress stability in the corporate and banking sector,
- a pledge of official forex reserves (EUR 35 billion) via VEB to extend foreign currency loans to help repay and service the private sector's foreign liabilities,
- a 75% increase in the deposit insurance limit to RUB 700,000 (ca. EUR 19,400) etc (see also Table 2).[16]

Moreover, in the first three weeks of October, three mid-sized credit institutions were bailed out by the state. Sviazbank (the 18th largest credit institution), Globeksbank (31st largest) and Sobinbank (number 39) were taken over by Vneshekonombank and other state-controlled institutions. In return, VEB was earmarked to receive deposits totaling EUR 2.8 billon from its owner. While the three players do not appear to be systemically important, the authorities seemed to be sending out a signal that they were even prepared to come to the rescue of medium-sized banks. The authorities certainly wish to rule out any popular impression that a crisis of the dimension of the 1998 crisis could repeat itself, including runs on banks etc. Of course,

[16] For a more comprehensive enumeration of the authorities' anti-crisis measures and a detailed comparative analysis of the course of the crisis of 2008 in Russia see "Anatomy of the crisis", in: Bogetic et al. 2008, p. 24–36.

such interventions may also raise dangers of moral hazard, namely that banks become inclined to more risky behavior, because they count on being bailed out by the state. The total amount of money pledged/ provided/ disbursed by the authorities in the framework of their anti-crisis measures is estimated at about EUR 150 billion (around 15% of Russian GDP). This unprecedented amount (to be) mobilized promises to constitute a significant burden on the budget and to boost inflation.

While the Russian financial sector and economy at least temporarily stabilized by late October 2008, the implementation of the above-mentioned measures and policies faced some serious problems: Firstly, the onlending mechanism to smaller illiquid banks has not worked well, given that most of the latter don't possess adequate collateral.[17] Therefore, many of these outfits have remained distressed and subject to stepped-up deposit withdrawals. Money did not "trickle down" as intended (Financial Times 2008b). Whereupon the CBR reacted by providing credits via auctions without requiring collateral. Moreover, official money injections in some cases are reported to have been swiftly converted into foreign currency (thus exerting pressure on the ruble's exchange rate) and shipped abroad – in some instances to bolster foreign parent banks in their own recapitalization endeavors (MGA 2008, see also Sapir 2008, p 42). Capital outflows skyrocketed to an unprecedented EUR 99 billion in the fourth quarter of 2008. Overnight interest rates on the interbank market remained on an elevated level and spiked to above 20% in November.

Thirdly, the continuing sharp erosion of the oil price (to under USD 40 per barrel in late December 2008) contributed to the persistent capital outflows, which prolonged the steep decline of the Moscow stock exchange (RTS). Moreover, the oil price dive fueled expectations that Russia's long-standing current account surplus could turn into a potentially sizable deficit soon, which in turn underpinned pressure on the ruble. While the CBR continued to run down its reserves in defense of the Russian currency, in mid-November it launched a controlled devaluation policy, while somewhat tightening forex controls.[18]

Over two months, this strategy incorporated at least 20 incremental widening steps of the ruble's currency corridor vis-à-vis its US dollar/ euro basket (55%

[17] A large number of Russian credit institutions continue to function as "pocket banks" or "agent banks" (i.e. they resemble extended financial departments of owner firms) (Barisitz 2007a, p. 17, 58).

[18] For example, the monetary authority cut the daily limit for currency swap auctions, in order to restrict short-selling of the ruble.

US dollar/ 45% euro). Over time, the widening steps became larger and more frequent. Some of these steps were combined with increases of the refinancing rate, which reached 13% (+2%) in December 2008. However, each time the corridor was widened, the spot rate quickly fell to the new weaker limit of the corridor. This resulted in the Russian currency's overall nominal depreciation from early August 2008 to mid-January 2009 of almost 40% against the US dollar and almost 20% against the euro.[19] The ruble thus attained its lowest level since the collapse of the USSR.

On 23 January 2009, after having carried out a particularly large widening step, the CBR declared the corridor widening exercise to be completed, at least for the next months. The monetary authority vowed to defend the ruble at the new lower limit of the band, if necessary. As of the 10 February, the Russian currency had declined and briefly touched the lower limit, before recovering again. Most experts expect the band to be tested in the next weeks. Despite the huge depreciation so far, official reserves have continued to decrease. Expressed in US dollars, they shrank 36% from their height of early August to reach USD 384 billion in early February (expressed in euros, they declined less – by 25% - due to the depreciation of the euro itself against the American currency in this period).

In early December 2008, Standard&Poor's downgraded Russia's long-term sovereign foreign currency debt rating by one notch (still within the investment grade class), citing the unrelenting erosion of foreign currency reserves. In early February 2009, Fitch followed suit. Commercial banks' liquidity and financial difficulties have most recently been compounded by repercussions of the persistent pressure on the ruble and its already substantial devaluation (see below). As alluded to earlier, Russia's limited attractiveness for foreign strategic investors has certainly played a role in heightening the country's exposure to the external shock and promises to remain an underlying risk factor in the future.

[19] Yet, in real-effective terms, the ruble had still appreciated by 4.5% in the twelve months to December 2008.

Table 6 Russian commercial banks under the impact of the crisis: closer focus on dynamics and structure of liabilities 2007–2008

	30 Jun 2007 (RUB bn)	gr. (% yoy)	Share in %	31 Dec 07 (RUB bn)	real gr. (% yoy)	Share in %	% of GDP	30 Jun 08 (RUB bn)	real gr. (% yoy)	Share in %	31 Aug 08 (RUB bn)	gr (% yoy)	share (%)	31 Oct 08 (RUB bn)	gr (% yoy)	share (%)	31 Dec 08 (RUB bn)	gr (% yoy)	share (%)	% of GDP[2]
Customers' funds[1]	10330.3	36.9	60.1	12232.2	26.9	60.7	37.1	14056.3	18.2	61.0	14516.9	18.5	60.4	14507.3	16.9	57.4	14732.9	6.3	52.6	35.5
- ruble-denominated	8222.0	.	47.8	9674.5	31.0	48.1	29.3	10995.5	16.2	47.7	11433.1	.	47.6	11070.7	.	43.8	9866.9	-10.0	35.2	23.8
- foreign currency-denominated	2108.3		12.3	2557.7	13.5	12.7	7.8	3060.8	26.1	13.3	3083.8		12.8	3436.6	.	13.6	4814.7	66.1	17.2	11.6
- corporate deposits, funds in current and other accounts	5032.7	41.2	29.3	7014.9	31.9	34.9	21.3	8198.2	41.5	35.6	8449.7	.	35.2	8862.9	.	35.1	8747.9	10.1	31.2	21.1
- household deposits	4348.1	28.1	25.3	5159.2	21.0	25.6	15.6	5771.4	15.3	25.0	5978.0	14.4	24.9	5535.6	3.7	21.9	5907.0	1.1	21.1	14.2
- of which: short-term (up to one year maturity)	1611.1	.	9.4	1939.9	17.0	9.6	5.9	2088.3	12.6	9.1	2119.3	11.0	8.8	1818.8	-4.9	7.2	2058.3	-6.4	7.3	5.0
- of which: long-term (more than one year maturity)	2737.0	.	15.9	3219.3	24.3	16.0	9.8	3683.1	16.9	16.0	3858.7	16.4	16.1	3716.1	8.6	14.7	3848.7	5.5	13.7	9.3
Loans and other funds received from other credit institutions	2103.9	51.5	12.2	2807.4	45.0	13.9	8.5	3321.5	37.2	14.4	3616.2	39.8	15.0	3785.2	42.9	15.0	3639.6	14.4	13.0	8.8
Loans and other funds received from the CBR	13.0	.	0.1	34.0	120.2	0.2	0.1	50.3	236.2	0.2	159.4	.	0.7	1178.0	.	4.7	3370.4	8649.3	12.0	8.1
Promissory notes (vekselia) and bank acceptances	717.6	0.9	4.2	822.2	-7.1	4.1	2.5	890.4	7.8	3.9	833.6	2.8	3.5	781.7	0.9	3.1	756.3	-18.8	2.7	1.8
Provisions for possible losses	525.0	27.0	3.1	586.3	15.8	2.9	1.8	687.8	13.8	3.0	726.4	13.6	3.0	833.4	27.6	3.3	1022.7	54.0	3.6	2.5
Other liabilities	1095.8		6.4	867.8	.	4.3	2.6	1121.3		4.6	1098.8	.	4.6	1114.6	.	4.4	1391.2		5.0	3.3
Bank funds and profits	2416.4	50.5	14.0	2809.2	40.8	14.0	8.5	2981.4	7.2	12.9	3081.7	5.9	12.8	3076.1	0.6	12.2	3109.2	-2.3	11.1	7.5
Total liabilities	17202.0	38.1	100	20125.1	28.8	100.0	61.0	23058.7	16.5	100	24033.0	16.4	100.0	25276.3	21.1	100.0	28022.3	22.9	100	67.5

[1] Excluding budgetary funds
[2] preliminary data

Table 7 Russian commercial banks under the impact of the crisis: closer focus on dynamics and structure of assets 2007–2008

	30 Jun 2007 (RUB bn)	gr. (% yoy)	Share in %	31 Dec 07 (RUB bn)	real gr. (% yoy)	Share in %	% of GDP	30 Jun 08 (RUB bn)	real gr. (% yoy)	Share in %	31 Aug 08 (RUB bn)	gr (% yoy)	share (%)	31 Oct 08 (RUB bn)	gr (% yoy)	share (%)	31 Dec 08 (RUB bn)	gr (% yoy)	share (%)	% of GDP[1]
Cash, precious metals and gemstones	306.1	21.3	1.8	501.7	21.7	2.5	1.5	450.8	28.0	2.0	445.9	18.0	1.9	631.4	59.4	2.5	829.3	45.9	3.0	2.0
Accounts with the CBR	1532.9	92.5	8.9	1294.7	21.1	6.4	3.9	1318.0	-25.3	5.7	1087.4	-2.4	4.5	867.9	-12.8	3.4	2078.7	41.7	7.4	5.0
Correspondent accounts with credit institutions	315.1		1.8	413.3	-7.2	2.1	1.3	396.4	9.3	1.7	452.3	.	1.9	681.1		2.7	1238.8	164.5	4.4	3.0
Securities acquired by banks	2725.9	30.7	15.8	2554.7	16.4	12.7	7.7	2347.5	-25.2	10.2	2317.5	-26.8	9.6	2164.7	-11.6	8.6	2365.2	-7.2	8.4	5.7
- debt obligations (bonds)	1824.0	27.6	10.6	1674.0	11.5	8.3	5.1	1608.6	-23.4	7.0	1649.2	-21.9	6.9	1590.5	5.2	6.3	1760.3	0.8	6.3	4.2
Credit claims	11217.2	37.0	65.2	14288.6	34.9	71.0	43.3	17366.4	34.5	75.3	18493.8	31.1	77.0	19582.5	28.6	77.5	19941.0	23.2	71.2	48.0
- on enterprises	7138.5	33.0	41.5	9316.0	35.4	46.3	28.2	11126.5	35.4	48.3	11822.7	31.8	49.2	12268.5	28.1	48.5	12509.7	18.5	44.6	30.1
- on households	.	.	.	2971.1	41.0	14.8	9.0	3589.8	.	15.6	3890.3	.	.	4083.0	.	16.2	4017.2	19.3	14.3	9.7
- on other banks	1117.1	30.6	6.5	1418.1	22.4	7.0	4.3	1801.7	40.1	7.8	1936.7	36.6	8.1	2380.3	42.4	9.4	2501.2	55.7	8.9	6.0
- ruble-denominated	8264.0	.	48.0	10487.8	39.1	52.1	31.8	12930.0	35.9	56.1	13592.4	31.7	56.6	13796.0	25.6	54.6	13914.1	17.1	49.7	33.5
- foreign currency-denominated	2953.2	.	17.2	3800.8	24.5	18.9	11.5	4436.4	30.2	19.2	4901.4	29.4	20.4	5786.4	36.5	22.9	6026.9	40.4	21.5	14.5
Fixed assets and inventories	478.6	23.3	2.8	434.8	16.0	2.2	1.3	491.1	-10.8	2.1	500.7	-12.7	2.1	511.7	-13.0	2.0	544.1	10.4	1.9	1.3
Other assets	626.2		3.6	633.3	.	3.1	.	688.5	.	3.0	735.4	.	3.1	837.0	.	3.3	1025.2	3.7	3.7	2.5
Total assets	17202.0	38.1	100.0	20125.1	28.8	100.0	61.0	23058.7	16.5	100.0	24033.0	16.4	100.0	25276.3	21.1	100.0	28022.3	22.9	100	67.5

[1] preliminary data

Source of tables 6 and 7: CBR

4.3.3. Banking sector development

The repercussions of the most recent international financial turmoil, of the decline of the oil price as well as of the ruble, are not yet fully reflected in available monthly banking sector indicators (status: end-2008). Notwithstanding substantial risks and notwithstanding earlier mentioned qualifications with respect to data quality, banking sector indicators have remained relatively robust – until most recently. As of mid-2008, certain structural factors were reported to have contributed to an improvement of the banking sector's risk profile, including greater customer and business line diversification, a lengthening track record of good performance, better overall management, and decreasing dependence on opportunistic gains and capital markets income (Trofimova and Bugie 2008, 2).

Following the swift expansion of the size of the banking sector in recent years, aggregate balance sheet growth (real terms, year on year) declined to 29% at end-2007 and 23% at end-2008 (Table 3). The slowdown appears to be largely triggered by the further slowdown, then stagnation, then decrease of household deposits[20], which, in turn, is probably due to two factors. The period until August 2008 was characterized by households' sensitive reaction to rising inflation and increasingly negative real interest rates as well as by the growing popularity of alternative modes of saving. The crisis-prone period starting in September 2008 (liquidity problems, ruble depreciation pressures, heightened uncertainty) features total deposits shrinking by 2% due to withdrawals. However, while ruble deposits have dropped sharply (by over 16% in September through December), foreign currency-denominated accounts have expanded (Table 6). Thus, the long-lasting steady decline of dollarization, that had already been halted by rising inflation in 2007, was abruptly reversed by the crisis: In the four months until end-December 2008, the share of forex (mostly US dollar) deposits in total deposits climbed back by no less than 12 percentage points to almost 33%, which corresponds to the level of the early years of the millennium.[21]

As a result, the share of retail deposits in total deposits fell from 45% at end-2006 to 40% two years later (Table 3). Loans and other funds received from other banks expanded over-proportionally, which reflects the increased importance – and strained capacity - of the interbank sector as a source of finance, particularly during liquidity pinches. Funds received from the CBR

[20] In the twelve months to end-2008, total household deposits increased by 1% (in real terms).

[21] The loan structure featured a similar about-face: While forex-denominated loans had steadily declined to 26% of total loans in June 2008, they reversed to a share of 30% in December.

grew multifold: In the six months to the end of 2008, their share in total bank liabilities grew from 0.2% to 12%. This reflects substantial disbursements of financial assistance late in the year.[22] The share of external debt in total bank liabilities had slightly risen to about one quarter in mid-2008. The respective share was probably significantly higher for many individual banks. About a third of banks' foreign borrowing is short-term (up to 12 months). Net foreign assets of the sector were negative at end-September 2008, amounting to 6% of GDP. Bank equity capital expanded from 6.3% of GDP at end-2006 to 9.2% at end-2008, largely on account of the above-alluded to Sberbank and Vneshtorgbank (VTB) IPOs, as well as, probably, of recapitalization measures in late 2008. Capital's share in assets rose slightly to 14%.

At least until the latest crisis, lending has remained the locomotive pushing the expansion of banking activity. Credit still grew by 23% in real terms (year on year) until end-December 2008. From end-August until end-December, the rate of expansion was 4%. As of end-2008, the total credit volume is estimated to have reached the record level of 48% of GDP. At this point, the credit volume surpassed the (shrinking) volume of deposits by 18%, which is problematic in the context of a liquidity crisis. To some degree comparable with develop-ments on the deposit side, corporate lending kept growing at decelerating rates of expansion, while retail lending decelerated sharply from high rates of increase (see Tables 3, 6).

Retail lending decelerated because of saturation in some market segments, but also because banks seem to have become more prudent and tightened lending standards, given that overdue household credits have remained at a relatively high level since mid-2007.[23] In late 2008, retail lending growth ground to a halt (Table 7). After steadily increasing to 21% of total lending at end-2007, the share of retail loans in total loans remained more or less stable until the fall of 2008. While mortgage credits continued to skyrocket, they no longer quadrupled, like in 2006, but "only" grew by over 130% (in real terms) in 2007, bringing the share of housing loans to 5% of total loans.[24] Housing construction slowed down substantially in the first half of 2008, and many construction projects were suspended in the fall of the year.

[22] These disbursements are responsible for the lion's share of the surprisingly sharp upward adjustment of the size of the sector's balance sheet in the last two months of 2008.

[23] During the crisis months of the fall of 2008, the share of overdue loans slightly rose to 3.6% (November).

[24] At end-March 2008, this share was 5.6% (see Table 3).

The strong expansion of corporate lending can certainly be explained by the fact that Russian economic growth and overall credit demand - while easing - have not flagged until most recently despite repercussions of economic instability. Moreover, given that these repercussions cut Russian corporates' cheap access to external capital markets, these firms were compelled to some degree to re-direct their borrowing activities back to (more expensive) domestic bank credits again (IMF 2008b, p. 6). Credit institutions also found liquidity for upholding loan growth by selling securities (mostly bonds, including government bonds). The total number of banks declined from 1165 in mid-2007 to 1108 at end-2008 (Table 3) (Tsentralny bank Rossiskoy Federatsii 2009b).

Given increased risks triggered by economic instability, margins between deposit and lending rates widened from mid-2007 to mid-2008 by about 2 percentage points, and again until end-November 2008 by another 2 percentage points to reach about 8%. The share of non-performing loans in total loans reportedly decreased further to 11% at end-2007, and the share of problem and bad loans is reported to have remained stable at 2.5% at end-September 2008 (notwithstanding the outbreak of the crisis). After declining previously, in the crisis circumstances, loan-loss reserves were slightly raised to 4.5% of total loans at end-2008. After increasing over the years until end-2006, profitability receded somewhat in 2007, but remained satisfactory (March 2008: ROE: 21.1%, ROA: 2.9%). Capital adequacy steadily weakened until mid-2008 as a result of strong asset growth, but then recovered to 16.8% at the end of the year, probably influenced by the authorities' financial assistance measures. After steadily moving downward until mid-year 2008, the liquidity ratio (share of highly liquid assets to total assets) marginally recovered to 12% at end-September 2008, again likely due to the authorities' anti-crisis interventions (Table 3) (Tsentralny bank Rossiskoy Federatsii 2009a).

As of early February 2009, the Russian banking sector remains in a vulnerable situation. Liquidity problems have been at least partly taken care of by disbursements from the authorities' sizable assistance package of September-October 2008. However, a further deterioration of the external financing environment could render coming debt rollovers exceedingly difficult and trigger new bank liquidity squeezes or even solvency problems. The persisting weakness of the ruble is pushing up re-dollarization, further jeopardizing deposits, and may trigger a loss of confidence and new bank runs. The ruble's slide could also give rise to loan defaults by unhedged borrowers, although this problem currently does not appear to be acute. The

real economy's downturn, which has been observed in Russia since late 2008, is certainly having a deteriorating impact on loan quality. While long-term credit demand for investment finance is contracting, short-term credit demand to refinance previous loans and to keep firms afloat may gain momentum.

4.4. Contemporary structure of the sector

Looking at the structure of the Russian banking sector, broken down by criteria of ownership and size, in the following the categorization introduced by the CBR is applied (Tsentralny bank Rossiskoy Federatsii 2007, p. 96–97; – 2008, p. 95). Accordingly, one can distinguish four groups of banks: a) Majority-state-owned banks, b) majority-foreign-owned banks, c) large private banks (the 200 largest banks, as measured by assets, excluding banks already included in the first two groups, d) medium and small-sized banks (all other banks excluding such already included in the first two groups). [25]

As depicted in Table 3, state-owned banks have held on to their dominant shares of around 40% of the sector's total assets and of its total equity capital (end-2007). As of end-2007, the three largest Russian banks, and five of the ten largest (in terms of assets) were majority state-owned. Sberbank remains by far the biggest player in the field, comprising almost a quarter of all banking assets (Table 8). Despite the liquidity squeeze, Sberbank's market share of household deposits declined to 51% at end-2007 (and to 50% half a year later).[26] At this point, Sberbank still accounted for nearly a third of corporate loans and for nearly 40% of loans to households.

Sberbank's outstanding feature remains its nation-wide sprawling network of about 20,000 branches and service posts (although this number has been cut by over 40% since the mid-1990s) and the fact that it is the only credit institution present in a number of outlying regions of the Federation – which, to some degree, may reflect an infrastructural or social role. The next-largest network comprises about 600 outlets. For a number of reasons, the authorities are not planning to privatize a majority stake in or break up Sberbank in the near future. Given the size of the institution, any radical adjustment might destabilize the situation. While any sale to a foreigner seems to be politically

[25] This corresponds to a slightly simplified presentation of the CBR's approach, in that medium and small sized Moscow-based and medium and small-sized regionally-based credit institutions are consolidated into one group.

[26] Thanks to this position, state-owned banks at end-2007 still held a total of 57% of retail deposits (Tsentralny bank Rossiskoy Federatsii 2008a, p. 22).

unacceptable, selling to domestic investors could be risky, given lingering doubts about the level of corporate governance. The authorities intend to leave Sberbank's status unchanged until competitors break its dominant position – which might happen in not too distant a future. Number two (with a market share of 7%) is Vneshtorgbank (VTB), the former foreign trade bank of the Russian Federation, which has turned more and more into a full-fledged state-owned universal bank. Gazprombank, owned by the giant natural gas concern, is Russia's third-largest credit institution. Other state-owned banks among the top ten Russian banks are Bank Moskvy (number five) and Rosselkhozbank (Table 8).

Large private domestically-owned banks lost terrain in 2007 and no longer made up over 40% of sector assets and capital, but 34–35% at the end of that year. Alfabank (number six), is the largest private domestically-owned bank (market share: 2.4%), and member of a diversified (less resource-oriented) FPG. Many other private credit institutions have been called "RawMat-banks", since they are owned by or affiliated to big raw material producers (Barisitz 2007a, p. 127). This goes for Uralsib Bank, connected to UralSib group, of which Nikoil company is a major member. The same is true for former Rosbank (attached to the Interros FPG, including Norilsk nikel, the largest nickel mining company of the world), Bank Petrokommerts (linked to Lukoil), Bank Soyuz (attached to Basic Element, including Rusal, one of the world's largest aluminum producers), and Surgutneftegazbank. Of course, Gazprombank could also claim to feature on this list. Similar to their larger competitors, small and medium-sized credit institutions' combined market share shrank by a couple of percentage points - to below 10% in 2007. Small and medium-sized banks report relatively high capital-to-asset ratios, but modest profitability (Tsentralny bank Rossiskoy Federatsii 2008a, p. 28).

Strong FDI inflows went on recently and foreign-owned banks lifted their shares in total assets and equity from about 12-13% at end-2006 to over 19% of assets and almost a quarter of equity capital at end-September 2008. Foreigners' share in total statutory capital even rose to 28% – partly a reflection of the Sberbank and VTB share offerings (Table 3). In April 2007, KBC acquired Absolut bank, ranked among the top 30 Russian banks at the time, for about EUR 760 million. In late 2007, Société Générale exercised its option to adjust its stake in Rosbank to 50% plus one share for EUR 1.2 billion - the biggest bank acquisition transaction so far in Russia (Les Echos 2007).[27] In early 2008, Société Générale united the operations of Rosbank and of Société

[27] Interros remains an important minority shareholder in Rosbank.

Générale Vostok, to become the largest foreign-owned credit institution and, indeed, the largest privately-owned bank (number 4) of the country. Other important foreign-owned banks are Raiffeisenbank, UniCredit Bank (until December 2007 called Mezhdunarodny Moskovsky Bank/ International Moscow Bank/IMB), and Citibank. Foreign-owned players have a relatively low share of deposits and primarily finance their credit expansion with foreign borrowing from their parent institutions.

Given favorable long-term growth prospects, Russia's banking market clearly remains attractive to foreign as well as to domestic strategic investors. This attractiveness implies that existing owners have not been in a hurry to sell their stakes and relinquish control – at least until the latest crisis. Where acquisition negotiations take place, they tend to be tough, as BNP Paribas and Dresdner Bank experienced in futile takeover attempts of, respectively, Russky Standart and Gazprombank in recent years. Although many formal restrictions for FDI in banking have been abolished, some still exist, like a ban on the opening of branches of foreign banks, which the government is looking to maintain in its negotiations on WTO accession. The authorities would also like to introduce some limit to foreign ownership of the national banking sector. (Currently no limit exists.) Overall, there appears to be a reserved approach to banking FDI, which may stiffen as takeovers rise in number (Trofimova et al. 2007, p. 15–16).

Summing up, recent changes of ownership structure bear some similarities and differences with developments in other transition countries: The domestically-owned private banking sector (while still relatively large in Russia), is squeezed in favor of expanding foreign-owned competitors, while the state sector retains undiminished weight (instead of contracting, as it has in other countries). One can certainly argue that the share of foreign-owned credit institutions is still rather small in Russia, compared to the situation in (smaller) transition countries, including new EU member states. On the other hand, this share is not that low by the standards of comparably large EU economies (e.g. 15% in France, 7% in Germany) and other large emerging markets (2% in China, 8% in India, 27% in Brazil) (Vinhas de Souza 2008, p. 57).

Russia's large credit institutions have become significant players by international standards. According to The Banker, 35 Russian banks ranked among the world's 1000 largest banks at end-2007, which is a net gain of eight from a year before. Sberbank ranked an impressive 33rd in the world. Furthermore, Sberbank, VTB and Gazprombank filled the three top slots in Central and Eastern Europe (The Banker 2008b; see also BOFIT 2008d).

Of course, the various and varying stock market crashes of the fall of 2008 (with Moscow's having been one the heftiest) will certainly have up-dated the above rankings.

Table 8 Russia's Top 10 Banks (at end 2007 measured by assets)

Rank	Credit Institution	Major owners (participation %)	Assets (EUR bn)	Market share (in total banking assets, %)
1	Sberbank	State (CBR, 58%) foreign portfolio investors (20%) domestic portfolio investors (16%)	136.8	24.4
2	Vneshtorgbank (VTB)	State (Finance Ministry, 77.5%) foreign portfolio investors (20%)	40.4	7.2
3	Gazprombank	Gazprom (51% state-owned)	21.3	3.8
4	Groupe Société Générale[1]	Société Générale (over 50%), Interros (FPG)[2]	14.6	2.6
5	Bank Moskvy	State (Moscow Municipality, 63%)	14.0	2.5
6	Alfa Bank	Alfa Group (FPG)[2]	13.5	2.4
7	Rosselkhozbank	State (Ministry of Agriculture	12.9	2.3
8	Raiffeisenbank	Raiffeisen International (100%)	11.2	2.0
9	UniCredit Bank[3]	Bank Austria-Creditanstalt (UniCredit, 100%)	10.1	1.8
10	Uralsib Bank	Uralsib Group (FPG)[2]	9.5	1.7

[1] Including Rosbank and Société Générale Vostok; increase of SocGen's stake in Rosbank from 20% to 50% plus one share carried out February 2008
[2] FPG= Finansovo-promyshlennaya gruppa (financial-industrial group)
[3] until December 2007: Mezhdunarodny moskovsky bank / International Moscow Bank, IMB
Source Raiffeisen Zentralbank, Bank Austria-Creditanstalt

5. Assessment and conclusions

5.1. Summary of banking sector development

At the turn of the millennium, Russian banking activities were still at a very modest level of development. Buoyed by strongly rising natural resource prices and major improvements in terms of trade, by prudent macroeconomic policies, some successful institutional and structural reforms, as well as political stability, Russian economic expansion has been strong throughout the last ten years. This expansion initially helped banks out of the doldrums of the 1998 crisis, before banks themselves started to contribute to the momentum of the recovery. Major banking reform measures were (finally) carried out in 2003–2005: the regulatory and supervisory framework was strengthened, IFRS was introduced for banks (however, with some limitations), and a general mandatory deposit insurance scheme was established. The enhanced screening of banks carried out in the framework of the implementation of the latter scheme indirectly contributed to banking turbulences in the summer of 2004, which, however, were quickly overcome. Soon, a credit boom set in, with loans growing on average by more than a third year-on-year in real terms until mid-2008. As of end-2008, the total credit volume had reached a level of 48% of GDP, and the balance sheet total had come to two thirds of GDP. Still, the attained levels of intermediation remain relatively modest, compared to what has been going on in a number of peer economies.

Buoyed by record-level CBR forex reserves, rising country ratings, full convertibility established in mid-2006, and abundant liquidity on international markets, Russian banks (as well as corporations) increasingly resorted to external capital markets to cheaply finance the credit boom. Banking sector foreign debt swiftly rose to over a fifth of total bank liabilities at end-2007. Russia also caught up, at least partly, with respect to FDI presence in the sector: The share of foreign-owned credit institutions in total banking assets doubled in two and a half years to reach 19% in September 2008; and foreigners' share in total statutory capital more than doubled to 28% in that time span.

As of the second half of 2007, however, the global financial turmoil triggered by the US subprime crisis strongly curtailed capital inflows and gave rise to sharp increases of interest rates on the domestic interbank market. Some medium and smaller-sized banks were practically cut off form market finance. But the CBR quickly intervened to provide liquidity through repo operations,

cutting reserve requirements and other measures. The government also invested some surplus budgetary means in the banking sector. While these measures temporarily helped ease the liquidity situation, inflation, driven i.a. by skyrocketing food and energy prices, almost doubled from mid-2007 to mid-2008, before somewhat relenting. Thus, the CBR and the government became confronted with a policy dilemma of opposing goals of monetary stability and banking soundness.

But this situation was soon eclipsed by the severe repercussions of the aggravation of the US and global crisis in September 2008, which became the main driving force of the precipitous oil price decline, which, in turn, constituted a major shock to and altered fundamentals for the Russian economy. The terms-of-trade shock came on top of the flare-up of geopolitical tensions and uncertainty emanating from the Georgian crisis. The confluence of unpleasant factors triggered accelerated capital outflows, a deep plunge of the Moscow stock exchange and a renewed and much more serious liquidity crisis in the banking sector, which underlined the Russian financial system's dependence on debt-creating capital inflows.

While the CBR heavily intervened to support the ruble, the authorities in the second half of September and the first half of October issued a package of strong measures (estimated at a total amount of EUR 150 billion or 15% of Russia's GDP) to inject liquidity and shape up markets. It consisted i.a. of a sharp cut of reserve requirements, sizable financial support for banks and corporations, a pledge of a about a tenth of official forex reserves to help service the private sector's foreign liabilities, and an increase of the deposit insurance limit. Moreover, in the first three weeks of October three mid-sized credit institutions were bailed out by the state. This helped re-stabilize the situation of the financial sector (for the moment). However, the unprecedented amount of funds (to be) mobilized promises to constitute a significant burden on the budget and to boost inflation.

Moreover, the deepening of the global crisis kept the oil price on a declining path, which contributed to upholding capital outflows from Russia and pressure on the ruble. After having spent a sizable amount of its large forex reserves in defense of the ruble, the CBR in November opted for a controlled devaluation strategy. However, despite a large number of small incremental devaluations (by widening the ruble's currency band step by step), by mid-January 2009, total reserves had fallen by between a fifth and a quarter since early August 2008 (depending on whether they are measured in euros or US dollars). In late January, after having carried out a relatively large widening

step, the CBR declared the corridor widening exercise to be completed, at least for the next months. Most analysts expect the band to be tested in the coming weeks.

Focusing on the most recently available banking sector indicators: The global financial turbulences since August 2007, the heightened price instability, and particularly, the severe financial crisis since September 2008, have dampened the overall expansion of Russian banking activity. Growth of household deposits slowed down sharply, since the latter have been saddled with increasingly negative interest rates; moreover, the aggravation of the crisis in September-October 2008 added concerns with respect to banks' liquidity and the stability of the ruble, triggering mounting withdrawals and shrinkage of household deposits. Retail (particularly mortgage) credit, that had been expanding very swiftly and had witnessed a rising level of overdue loans, slowed down sharply. Corporate loan growth remained more robust, but also decelerated in late 2008.

Non-performing loans (as a share of total loans) are reported to have been steadily declining in recent years, which is not surprising in a credit boom, though. Loan-loss reserves had also been shrinking (in relative terms), but then somewhat recovered in the fall of 2008, which may have been influenced by the authorities' anti-crisis intervention. Liquidity indicators have shown a steady decline – which recently came to a halt. While profitability had been on the rise until the outbreak of the global turmoil (August 2007), it has somewhat receded since, but still remains healthy. Capital adequacy has been slowly decreasing, but recently experienced an up-tick, and in any case remains well within regulatory limits.

5.2. Risk assessment and conclusions

The most recent major financial crisis has complicated risk assessment, given the difficulty of separating structural from macroeconomic and longer-term from transitory factors. Although the Russian banking system demonstrated reassuring resilience to the impact of the U.S. and global financial turmoil until September 2008, and although twin surpluses and record-level foreign currency reserves provided a measure of financial security, many vulnerabilities remained. In assessments reached in the spring and the summer of 2008, financial experts, including those of the CBR and the IMF (see Tsentralny bank Rossiskoy Federatsii 2008a; IMF 2008c) agreed that credit risk remained the dominating risk for the banking sector in Russia,

followed by liquidity risk. Market risks (mostly interest rate, maturity and currency risks) were seen less important from the perspective of systemic stability, or more difficult to gauge. In the event, the crisis that broke out in September 2008 manifested itself (once again) in the materialization of liquidity and market risks, followed by declining credit quality. While these problems were also rooted in domestic shortcomings, their severity was largely externally triggered.

As borne out by the crisis: Given the still fragile/ malfunctioning interbank market, *liquidity risk* continues to present a problem in particular for the numerous domestically-owned smaller and medium-sized banks (which account for about one third of total assets). These institutions, typically “pocket banks” (see above), tend to be equipped with a limited deposit base and to lack necessary collateral. Their access to the interbank market has been all but cut off by the most recent crisis. While CBR emergency liquidity injections have helped in some cases, major structural difficulties remain. In contrast, state-owned and foreign-owned credit institutions are more likely to have potent financial backers. Another serious liquidity problem may arise, depending on the degree to which Russian banks’ access to external refinancing – in particular for debt rollover – in restricted in 2009.

Looking at market risks: After the substantial weakening of the ruble in recent months, the risk of (further) depreciation has not subsided. Speculation appears to be playing an important role in pushing exchange rate movement. If the *currency risk* is not brought under control soon, accelerating withdrawals from bank accounts could create new or exacerbate existing liquidity problems. Accelerated withdrawals – in conjunction with extremely tight external refinancing conditions - could sap confidence in the sector, step up bank runs, and even trigger a *systemic crisis*. Withering hard-won confidence in the Russian currency and swiftly returning dollarization can also reduce the effectiveness of monetary policy at a crucial moment. While there is not a major currency mismatch between deposits (33% dollarized at end-2008) and loans (30% dollarized), a substantial further depreciation might trigger serious payment problems for unhedged foreign currency borrowers - notably households, thus turning currency risk into indirect credit risk for banks. On a positive note, retail lending in Russia has not exceeded about one fifth of total loans and has therefore not reached the risky levels observed in some peer countries (like Ukraine).

The incipient recession is certainly worsening borrowers’ creditworthiness and dampening credit demand. Cyclically deteriorating quality of loan books

reflects rising *credit risk*. More generally, many credit institutions continue to exhibit substantial single-name concentrations in their lending as well as borrowing portfolios, which signals vulnerability to individual counterparty shocks. This is related to a familiar concern: connected lending: while transparency has clearly improved since the implementation of the deposit insurance regime (2004–2005), information on related party exposures, beneficial ownership and group affiliations still does not appear to be satisfactory, which makes it difficult to assess intra-group exposures and which limits credit risk assessment. Despite improvements, in many banks risk management still tends to be limited by lack of appropriate data and rudimentary approaches (IMF 2008c, p. 17–18).

Stress tests recently carried out by the CBR simulated a deterioration of the economic situation triggered by a sharp drop of the oil price. Their results show aggregate losses for the banking sector as of 1 October 2008 amounting to 6.0% of GDP in a conservative scenario, and to 6.6% of GDP in a pessimistic scenario (Bezdudny 2008, p. 26). Thus, both scenarios provide for the wiping out of a large part of banks' capital, which stood at 7.8% of GDP at end-September 2008.

While weakening in recent months, *shock absorbing factors* still appear to be relatively strong: Profitability and capital adequacy are satisfactory. However, reported data may still have shortcomings. Reported capital may be overstated and may mask some actual undercapitalization because of persisting weaknesses in the area of loan classification and provisioning practices. Uncertainties also exist about the accuracy of collateral valuation. Largely reflecting these shortcomings, accounting and supervision practices still need to advance further on their path to a risk-oriented approach (allowing use of professional judgment) (IMF 2008c, p. 22–23). In any case, Russian gross official reserves certainly represent an ultimate shock absorbing factor that has already been generously used as an anti-crisis instrument and that may be compared to the size of the country's gross external debt (incl. bank debt): Partly thanks to the skyrocketing oil price until July 2008, gross reserves overtook gross debt in 2007 and came to 108% of debt at end-June 2008. At end-September, reserves still stood at 103% of liabilities. Yet three to four months later, this ratio has probably dipped below 100% again (perhaps to as low as 90%). Still, the world's third-largest gross reserves remain a sizable cushion, as long as substantial amounts are not lost through capital flight.

Current *short and medium-term perspectives* for the Russian banking sector appear uncertain, while long-term perspectives remain reassuring, given the

still immense catching-up potential embodied in the sector. The immediate future will be influenced by the way the global financial crisis further unfolds and which effect it has on world economic growth and on oil and commodity prices. Also, the degree to which the Russian financial rescue measures are effective in reining in the domestic banking crisis will play a role. While Russian banks' margins and profitability have remained high until most recently, profitability has deteriorated in the short run because of incurred stock market losses and because of increased provisioning and the re-building of liquidity buffers. Lending is expected to further decelerate, with knock-on effects on the real sector.

Barring lasting irrational price developments, government interventions should prevent a fundamental destabilization of the major banks. However, many smaller credit institutions are likely to face continued funding pressures, and some of these smaller outfits might be forced to exit the market or be taken over by larger competitors (with or without the help of the state). In this sense, the current financial crisis may set the stage for a *reshaping of the market* or a shake-out (Neue Zürcher Zeitung 2008b, p. 10)[28]. Once trust has been regained, FDI inflows into the sector may resume. As was the case in earlier crises, the large state-owned (or otherwise well-connected) banks are likely to emerge from the current turmoil with – relatively - strengthened positions; this advantage will however come under pressure and may erode in the following years, given probably increased competition from foreign strategic investors.

Once the crisis is overcome, the authorities should move forward with structural/ institutional reforms, which may help reduce the banking sector's vulnerability and exposure to external shocks. Reform measures advocated by international organizations and private sector observers include: enhancing banks' liquidity management and raising transparency of the interbank market; strengthening of risk management – particularly of loan review practices; toughening of single-name concentration regulations, incl. to related parties; simplification of administrative procedures regarding mergers & acquisitions; introduction of consolidated supervision of banking groups; tightening of capital adequacy, loan classification and provisioning standards; tightening of valuation rules for collateral; and improvement of corporate governance and the of rule of law more generally.

[28] At a conference of top Russian bankers in December 2008, the consensus was that there will be about 800 credit institutions left by the end of 2009 (Aris 2009, p. 65). That said, previous crises – even the 1998 meltdown – did not produce a decisive "cull" of smaller banks.

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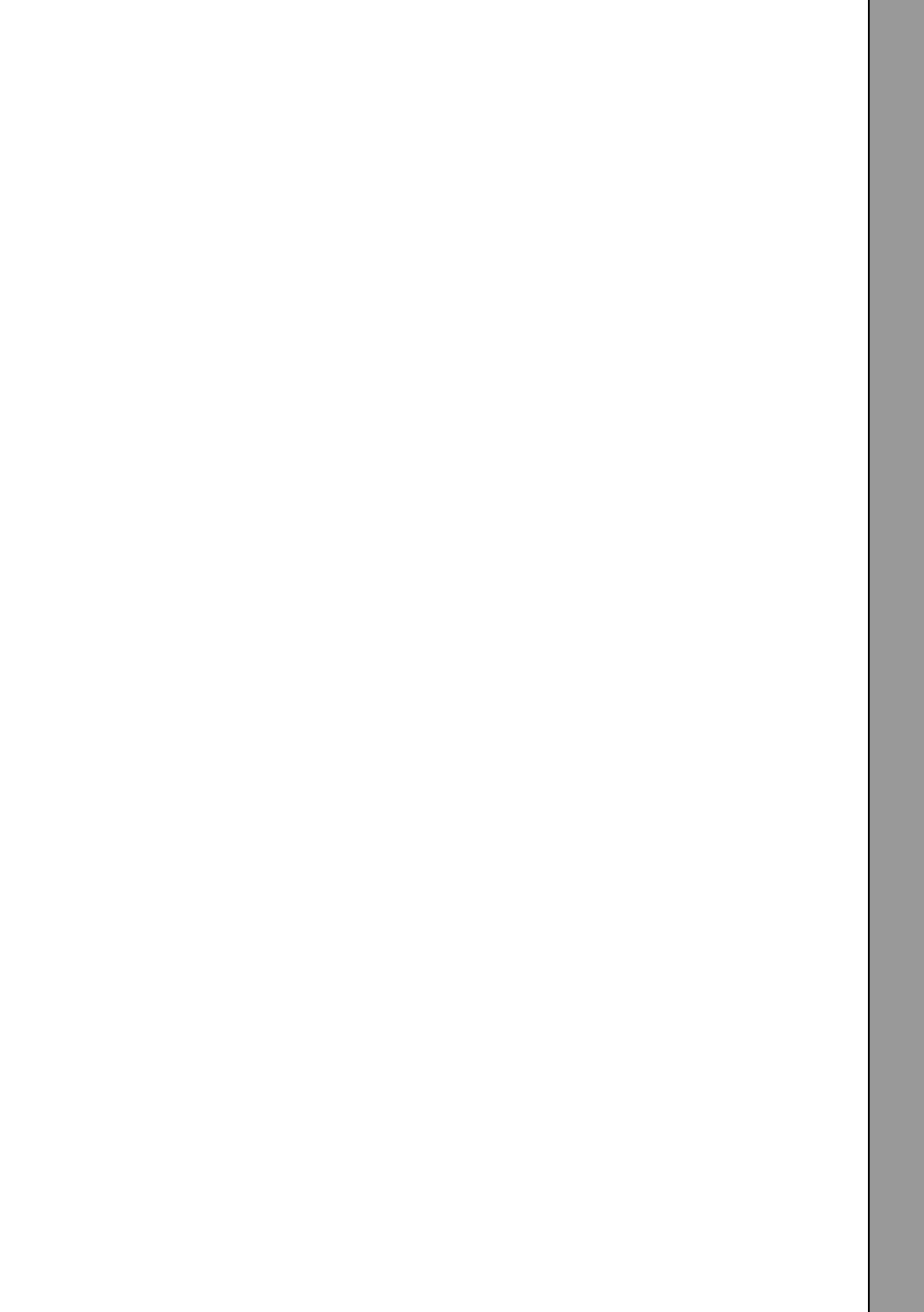

5. BANKS AND FINANCIAL REFORM: THEIR ROLE IN SUSTAINING RUSSIA'S GROWTH

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1. Abstract

This paper charts key aspects of the expansion of Russia's banking systems following the deep financial and currency crisis of 1998. It puts the growth of Russian banks into the context of the expansion of the financial system more broadly, and studies the impact of key regulatory reforms, in particular the full opening of the capital account in 2006. The role of bank credit in supporting Russia's growth is assessed on the basis of industry specific trends in bank credit and investment. The paper concludes with a review of the impact of the ongoing disruptions in international credit markets on Russian banks, and provide an outlook on its likely impact on the nature of bank credit, and the structure of the banking system.

[1] This note draws largely on joint work with Erik Berglof, forthcoming in *Journal of Comparative Economics*.

2. Introduction

Up to about mid 2008 the Russian economy experienced an impressive growth spurt. After a disappointing 1990s, and the deep recession of 1998, annual growth rates between 2000 and 2007 averaged about seven per cent. Since then the Russian financial system has been impacted by the retrenchment of international investors from emerging markets, and a severe liquidity and confidence crisis took hold, dimming growth prospects for the medium term future.

Apart from the abundant access to international capital, many factors that have supported Russia's recent growth are set to diminish or have already done so. These factors include the substantial boost from the terms of trade which reversed from 2008; the implicit subsidy to Russian industry through discounted domestic energy prices; and the benefits of slack capacity following the 1998 recession.

One view is hence that Russia's recent growth can largely be attributed to such temporary factors. Many countries have experienced episodes of rapid growth, but few have been able to sustain high growth rates over longer periods of time.[2] Typically, growth accelerations that are set off by external shocks eventually fizzle out, while economic reforms produced sustainable accelerations.

A rival view is that Russia's growth spurt – indeed longer term potential growth – has benefited from the reforms implemented in the early part of the Putin administration. This article explores this issue with a focus on the financial sector. In Russia, as elsewhere in the transition region, much of the underlying growth stimulus has been attributed to financial development, primarily, but not only, banking sector development. This now appears established through a number of empirical studies, as for instance the industry level study of Rajan and Zingales (1998).

However, as documented in Berglof and Bolton (2002) there was no strong link between economic growth and financial development during the 1990s in most transition countries in Central and Eastern Europe and the former Soviet Union. Some countries experienced rapid economic growth with little financial development, while others had periods of financial

[2] Hausmann et al. (2004) document 84 such 'growth spurts' over the post-WWII period, finding that countries typically experience periods of growth, stagnation and decline in rapid succession.

expansion with little or no growth. Even in those countries where over time a positive correlation between finance and growth developed, there was little microeconomic evidence that the financial sector actively supported growth. Investments were overwhelmingly financed through retained earnings, and what little external finance was raised came from foreign direct investment.

In other words, throughout the first decade of transition in Eastern Europe economic growth and financial development essentially took place in parallel without much interaction. Both developments were driven by third variables: on one hand, a combination of factors that determined the ability of the state to ensure macroeconomic stability and resist pressures from special interests, and on the other hand, microeconomic variables guaranteeing rule of law and contract enforcement for individual actors in the economy.

No country illustrates these findings more clearly than Russia. The Russian economy experienced a particularly deep and protracted output fall, while credit to the private sector increased continuously until 1998. Even more strikingly, the financial crisis – by any standards a severe reversal in financial development – was followed by the recent growth spurt.

Yet, a stable macroeconomic environment and responsible fiscal policies since 2000 have created favorable conditions for financial development. Unlike in the 1990s the financial sector has undoubtedly supported economic growth since then.

Regulatory improvements and, more importantly, better enforcement combined with rapid development of individual institutions provide much better conditions for sustained credit expansion. The disruption to credit growth that emerged most starkly since September 2008 make this link between the banking sector and the real economy abundantly clear.

The next section below will set out the macroeconomic context for Russia's growth spurt, and then look at the specific role that the expansion of the financial sector has played in fostering that period of strong growth. This is followed by a review of the key reforms that spurred this financial expansion, and the role of bank credit in supporting growth. The government that took office in May 2008 will likely contend with much lower growth in its first few years in office. It has still not given up on an ambitious reform agenda, some of which was shaped around the more recent crisis events. The concluding section on what reform measures are now required in the financial sector to revive growth could hence provide some context to these efforts.

3. Russia’s growth spurt

Disentangling external effects from the contribution of domestic reforms is not easy anywhere, but the Russian case makes the challenge particularly daunting. Russia’s growth spurt is rather different from those of most other developing countries. It follows a transitional recession which was both deeper and more protracted than was the case in Central and Eastern Europe. Annual growth in the second half of the 1990s was a mere 2 per cent on average.

Since growth picked up in 2000 private consumption was the key driver of growth, stimulating a better utilization of existing capacity. Investment in new capacity was limited and only picked up in the last few years of President Putin’s second term. Hence, growth has primarily been driven by private consumption and investment (at average real growth rates of about 12 and 16 per cent respectively over the period 2005–2007), with fiscal expansion being a minor stimulus (though this is currently changing), and net exports detracting from growth due to extremely buoyant import.

There is no question that the country’s growth and public finances have benefited from a positive terms-of-trade shock in the form of the dramatic increases in the world prices on energy and commodities. Hydrocarbon products and metals continued to account for just under 80 per cent of exports in 2007, and OECD (2006) estimated the growth impulse from the terms of trade improvements alone at over 2 per cent per year in 2004–2005. More recently, substantial private capital inflows provided an additional stimulus, and unlike export revenues from the hydrocarbons sectors, their impact on domestic demand could not be easily sterilized. The competitiveness of Russian industry was further underpinned by the real depreciation immediately following the 1998 crisis and the ability of companies to exploit underutilized capital stocks.

In terms of macroeconomic policy the authorities made reasonably good use of this temporary fillip. The improvement in key indicators is perhaps most evident in the pre-payment of most public external debt. More fundamentally, budget management and medium term planning have been strengthened and extraordinary fiscal reserves have been accumulated to weather future shocks. The scope of the government’s stabilization funds was broadened and their respective roles as stabilization and savings vehicles clarified.

This strengthening of fiscal governance underpinned to greater confidence of foreign investors in Russian financial stability. Yet, a substantial fiscal loosening took place in the run-up to the presidential election in 2008 and, following the liquidity crisis of late 2008, a significant part of the savings fund was invested in various measures to support banks' capital base.

The central bank's pursuit of exchange rate stability, evident in a rigid peg to a dollar-euro basket, led to large injections of liquidity through the foreign exchange market, and a rapid expansion in money supply. The rapid increase in inflation rates since mid-2007 was as much a reflection of international food price inflation as of this monetary stimulus. Clearly, deeply negative real interest rates resulted throughout a five year period to 2008, providing a boon to banking sector expansion. Only in August 2008, when speculative inflows in anticipation of further rouble appreciation threatened to aggravate an already serious inflation problem, was exchange rate policy loosened in a meaningful way.

Russia's relatively orthodox macroeconomic policy at the same time built up an important vulnerability. In 2005 Russia achieved 'investment grade' status by all three principal rating agencies and began to attract inflows of portfolio investment and bank funding on a substantial scale, reversing the tradition net outflow of private capital. This was clearly encouraged, as the nascent domestic bond market provided an increasingly important alternative funding instrument for Russian enterprises. In 2006 the government then fully eliminated the remaining capital account restrictions. Gross debt of Russian banks went up by about USD 110bn in 2006–07 alone, and the banking system's net foreign liabilities increased from 22 to 62 per cent of system capital. Banks were now in a position to take full advantage of abundant international liquidity, a funding source that would put the banking system at grave risk only in the following year.

The increased pace of growth also coincided with a significant strengthening of state influence over key sectors in the economy, particularly over energy and other raw materials. The Putin administration clearly demonstrated its desire to further strengthen the role of the state. The de-politicization of investment decisions central to early reforms was reversed on a broad scale. Much of the increased state control was assumed by the federal administration as super-regions were introduced, the constitutional powers of the Federation Council was weakened, and regional gubernatorial elections replaced by presidential appointments. Large parts of Russian industry and banking sector continued to draw on state support – whether explicit or implicit – and benefited from discounted funding costs in international capital markets that assumed such backing.

4. Financial reform and growth

It is clearly difficult to dis-entangle the relative roles of reforms and macroeconomic conditions in explaining the growth of credit in Russia. The Putin administration devoted considerable effort on reforming the financial sector in its early years. Yet, by most standards the banking sector remains relatively small, and plagued by a large number of under-capitalised, and often intransparent banks.

In the 1990s the development of both banks and financial markets was geared towards financing the government's financing needs. Banks played a minimal role in financing the private sector. Since 2000 the consolidated government sector has been running substantial surpluses, and households and corporations consequently were able to rapidly expand their bank borrowing. Correctly, the focus of financial sector has been on strengthening the banking system and the financial markets supporting its growth. There were also reforms to promote corporate bond markets, though despite their recent very rapid growth, market-based finance of corporate investment has remained secondary.

A series of studies has examined causes and timing of the spectacular expansion in private credit across the transition region. In Russia, the 'turning point' – the beginning of a sustained and rapid expansion in bank credit to the private sector – came in 2001 when the credit ratio increased by 3.3 percentage points of GDP (Table 1). This represented a sharp recovery from the credit losses that accrued to Russian banks during the 1998 financial crisis. The renewed expansion in private sector credit came relatively late compared to most of the transition region, and certainly compared to the seven countries for which Cotarelli et al. (2003) identify the start of such a growth period between 1992 and 1998.[3] Unlike other transition countries, even at that starting point of financial deepening, Russia had very limited experience of foreign entry into the banking sector, or of bank privatization. Since then, bank credit to the private sector in Russia has expanded by over 20 per cent of GDP, averaging about 3.8 percentage points per year.

By end-2007 the ratio in GDP of credit to the non-financial sector had expanded to 36 per cent. This was a formidable pace by the standards of other

[3] Cotarelli et al. (2003) define such a turning point as a sustained increase in the private credit to GDP ratio by more than 1.5 per cent of GDP per year.

transition countries in central and south-eastern Europe, even though the depth of credit to the private sector still remains below that of comparable countries, such as Ukraine or Kazakhstan. By early 2009 there were clear signs that this expansion had come to a halt after less than eight years, with banks' external funding options severely constrained, deposits falling, and non-financial enterprises confronting severe constraints in accessing bank credit.

Even though the domestic banking sector dominates other sources of debt finance to the corporate sector, substantial additional credit was made availabile through issuance in the rapidly growing domestic bond market (in 2007 amounting to RUB 470bn., or about 1.5 per cent of GDP), and through international bank lending (USD 94bn by non-financial enterprises in 2007, roughly 7 per cent of GDP). Both sources of finance are, however, primarily only open to large enterprises.

Table 1: Accounts of the Russian banking system (end-year stocks in per cent of annual GDP)

	2001	2002	2003	2004	2005	2006	2007	2001–07, av. Change p.a.
Total assets of the banking sector	34.3	35.5	38.4	39.1	39.4	46.3	54.4	3.3
Net foreign asset position	2.3	1.8	–0.6	–1.1	–1.8	–4.0	–5.5	
Net credit to the general government	5.8	5.8	5.0	3.6	2.2	1.8	1.7	
Credit to the private sector[1]	13.5	16.2	19.6	22.3	24.8	29.3	36.3	3.8
– to enterprises	12.4	14.9	17.4	18.7	19.4	21.6	26.5	2.3
– to households	1.1	1.3	2.3	3.6	5.5	7.7	9.8	1.5
Deposits by the public	18.0	19.5	21.2	22.1	24.0	27.2	31.9	2.0
Net deposits by the government	0.8	0.6	0.6	0.8	0.9	1.1	0.9	
Bank capital	3.9	4.5	5.2	5.3	5.8	6.3	8.7	
Interest rates on bank lending	17.9	15.7	13.0	11.4	10.7	10.5	10.0	
In real terms[2]	–1.8	–0.1	0.4	–1.5	0.2	1.4	–1.0	

Notes: [1] Excluding to other financial institutions;
[2] End of year levels, deflated at current CPI inflation rates
Source: CBR

As in other transition countries, this increased use of credit by the private sector reflects higher income levels, reduced demands of the public sector

on bank funding, and improved institutional quality.[4] While one can identify the funding sources of growth in bank assets it is difficult to disentangle the relative role of macroeconomic and institutional factors, and this is not attempted here.

Table 1 clearly identifies a sharp drop in net credit extended by the banking system to the public sector. Following the federal government's default in the 1998 crisis, public finances at both federal and regional level quickly recovered, allowing private borrowers to 'crowd in' on bank credit. The reduction in the banking system's net foreign assets was another important funding source. External funding accelerated in recent years, supported by the improvement in the sovereign credit rating to investment grade in 2004, and improvements in transparency and corporate governance standards that allowed Russian banks to access the international syndicated loan and bond markets. Yet, it is clear that the overwhelming funding source of the growth in Russian private sector credit were household deposits themselves, which increased by nearly 10 per cent of GDP in the seven years since 2001.

The growth in these bank sector funding sources of course in part reflects the broader macroeconomic recovery following the 1998 crisis. As real wages increased by an average of 14 per cent per year over this period since 2001, the banking sector benefited from substantial deposit growth. The liquidity inflows through the trade account, and, later, through the capital account translated into rapid monetary expansion, and funding costs from deposits and in the interbank markets have remained negative in real terms throughout this seven year period. Clearly, this constituted a highly propitious environment for financial expansion.

Unlike in Eastern Europe, the structure of Russia's banking sector has changed very little. The share of state-owned banks in system assets remains undiminished at about 45 per cent in 2007, and the share accounted by majority foreign-owned bank has only marginally increased to about 12 per cent, well below the 50–80 per cent foreign ownership shares typical of central and southeastern Europe. Elsewhere in the transition region the completion of bank privatization marked an important turning point for the banking sector, following which banks' role in intermediating capital expanded rapidly.[5]

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[4] See for instance EBRD (2006) for a review of previous studies and some new estimations of the discrepancy between actual and equilibrium financial depth.

[5] Hanousek and Kocenda (2007).

Despite the absence of such high quality foreign bank subsidiaries, the sustained strong increase in both foreign borrowing and in household deposits evident in Table 1 underline what is clearly greater confidence on the side of creditors and depositors. Nevertheless deposit flight from the system as a whole and towards state banks around periods of banking system instability in both 2004 and 2008 suggests this confidence remains fragile.

The banking sector of course also benefited from a positive reform environment, at least in the early years of this expansion. To put the role of structural reforms into context, Figure 1 depicts the progress in overall reforms in Russia since the beginning of the transition process and broken down by sub-periods. Improvements in all nine structural reform areas assessed annually by the EBRD were respectable in the first Putin administration, though they slowed markedly thereafter. Russia's average reform score still remains well below all central European countries, and most southeastern European countries.[6] During the early years of this decade, numerous reforms were initiated, including in contract enforcement and corporate governance, from which the expansion in bank credit benefited. One key element was the tax reform of 2000–2001, which moved a large part of cash salary payments into the formal sector, and gave further incentives to households to hold bank deposits.

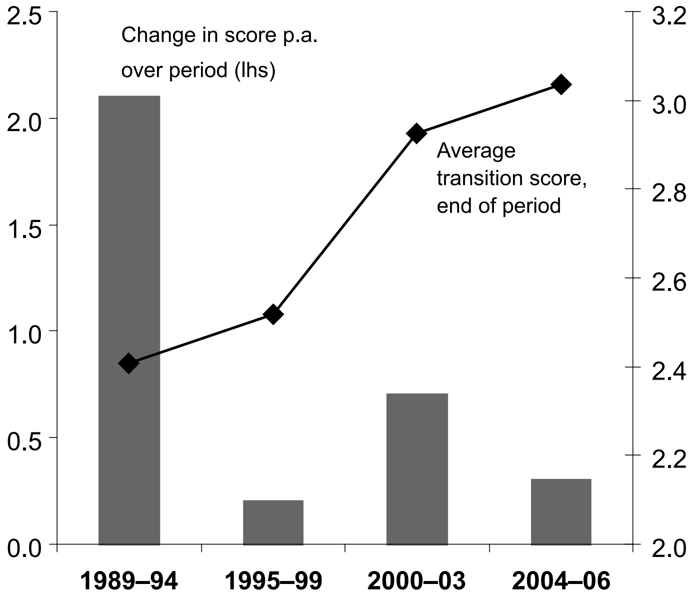
The banking sector itself was subject of a number of reforms summarized in Table 2. Most notable was the introduction of the deposit insurance scheme in 2003. While over two thirds of private deposits remain with state banks that already benefit from an implicit state guarantee, the new system made this state support explicit, and made admission of banks into the system conditional on meeting a range of prudential standards, though these standards have not really served as an effective discipline, and may even have aggravated moral hazard problems (Vernikov (2007)). This exposes a broader weakness with bank prudential standards in a corporate environment that still lacks in transparency and governance standards.

Even though regulatory reform slowed markedly in the second half of the Putin administration, some positive change was driven by private banks themselves. International accounting standards, for instance, were increasingly adopted by both banks and borrowing firms. Private sector initiatives, like the MosPrime index to promote transparency in interbank markets, were also key to the improved functioning of money markets. A recent study of

[6] These assessments of structural reform cover all areas of structural reform, including privatisation, corporate governance, price liberalisation, the trade regime, banking and non-banking sector reform, and infrastructure.

accounting information and corporate governance standards show significant improvements over the last decade (EBRD/IMF (2006)).

Figure 1. Progress in structural reform*



* Russian EBRD transition scores (p.a. change and end period averages, 1989–2006)
Source: EBRD Transition Reports.

Table 2: Recent key reforms in Russia's banking sector

1998	• Federal law "On Mortgages"
2003	• 'Fit and proper' standards for bank owners, and greater scrutiny of sources of bank capital • Improved enforcement of banks' rights over pledged collateral • Limited reporting requirements based on international standards (IFRS) • Law on mortgage backed securities
2004	• Introduction of the deposit insurance system (admission of individual banks conditional on compliance with a set of 12 prudential standards) • Minimum capital requirements for newly created banks (waived for existing banks until 2010).
2005	• Law 'On Credit Histories' and introduction of credit bureaux • Mortgage legislation, including on securitisation
2006	• Complete elimination of capital account controls

What role did the rapid expansion in bank credit play in Russia's growth? Macroeconomic figures would suggest the impetus has been modest. In 2006, the last year before the disruption through the international credit crisis, the banking sector expanded its net credit to non-financial enterprises by about RUB 1 trillion (about 4.6 per cent of 2005 GDP). By comparison the capitalization on the highly dynamic domestic corporate bond market increased by only about 1.6 percentage points of GDP. This was a substantial expansion in the financial sector, though insufficient to explain the expansion of the corporate sector in that year (when gross investment alone grew by about 17 per cent).

Rosstat figures show that in 2007 bank credit accounted for 9.4 per cent of funding for fixed capital investment. This share has risen steadily over the past 8 years (from about 3 per cent in 2000), though remains small compared to equity funds (primarily retained earnings) and budgetary funds, which together accounted for 62 per cent of investment finance. To a large extent this reflects the sector composition of Russian investment. Nearly half of the 2007 investment volume was in just three sectors – natural resources (oil, gas and metals), transport and utilities – and only about 18 per cent in manufacturing. The former set of sectors, of course, benefited from sustained increases in export prices and profitability, and more recently, from the expansion in state funding for investment in infrastructure and energy sector development.

Moreover, data for 16 manufacturing and services sectors suggest that only four sectors showed a clear excess of capital expenditure budgets over cash flows in 2006.[7] Again, this underlines that most sectors are either highly profitable, or not rapidly expanding capital stocks, or both. This does not seem to be an environment in which expanding bank credit supports the growth of sectors that show high financial dependence, in the sense defined by Rajan and Zingales (1998). Their findings – that industrial sectors with greater need for external finance develop disproportionately faster in the context of highly developed financial markets – do not yet seem to apply to Russia. This, though, is a result of the lack of diversification in the corporate sector, and its inadequate investment.

The changing nature of private sector credit is more illuminating than the macroeconomic flow of funds. As competition in the banking sector intensified and net lending margins in the traditional products such as credit to medium sized enterprises shrank, most Russian banks rapidly diversified into lending

[7] These figures were computed on the basis of the 100 largest companies in each sector from the ORBIS database.

to retail customers and SMEs. Even though Russian SMEs still only accounted for about 12 per cent of total employment in 2007, growth in employment and value added has been above average. EBRD/World Bank business surveys suggest that, as in the broader figures for corporate investment as a whole, the share of new investment financed through bank credit is still small.[8] However, the expansion into SME lending has been particularly marked in Russia's regions, and outside the urban centres.[9] As in a number of other transition countries greater access to credit by SMEs alleviated credit constraints, and thereby supported rapid productivity growth.[10]

Bank credit also appeared to increasingly meet the financing requirements of medium sized enterprises. Russia still suffers from a severe lack of long term funding in the financial system. This is in part a result of institutional factors, such as the lack of secure long term retail deposits, or of institutional investment in long term securities, though also attributed to a history of monetary instability. Yet, Table 3 demonstrates that the share of credit to enterprises at maturities above one year rose strongly in the rouble component of credit. At least until the onset of the international credit crisis and the renewed rise in inflation, expectations of macroeconomic stability supported this maturity lengthening. Average maturities of bank liabilities lengthened, including through a greater share of international bank borrowing, allowing banks to lengthen terms on their assets while limiting maturity mismatches. An illustration of such maturity lengthening is the mortgage market. Maximum maturities lengthened to 30 years while competition was beginning to bring rates down. Growth was stronger in Russia's regions than in Moscow. This fuelled a boom in construction, which showed 16 per cent growth in 2007.

Equally remarkable was the shift of the banking system out of foreign currency. Russia's financial and payments system was traditionally highly dollarised. Immediately following the financial crisis and the steep rouble devaluation in 1998, about fifty per cent of cash in circulation was in the US currency. Dollarisation of bank credit of course aggravates currency exposures among borrowers without natural hedges, whose solvency may be at risk once the local currency depreciates. The highly commodity dependent export structure, and the more volatile capital flows of recent years, expose Russia to such currency volatility. In 2007, only about one fifth of total bank credit

[8] The surveys primarily sample SMEs, and estimate the share of bank credit in capital expenditures at about 12 per cent.

[9] Berkowitz and De Jong (2008) document the relationship between bank credit and growth in Russia's regions.

[10] See Joeveer et al (2006).

to the private sector was still in foreign currency, and this share continues to decline. The vast majority of foreign currency credit was to enterprises, most of which are likely to have natural hedges, such as export revenues. Reduced credit risk due to maturity or currency mismatches should encourage Russia's corporate to engage in sustained investment. Where banks alleviate credit constraints, borrowers are likely to engage in productive investment, further underpinning growth.

Table 3: Key indicators of bank credit to the non-financial corporate sector

	2001	2002	2003	2004	2005	2006	2007
Share of corp. credit in roubles at maturities							
– above one year	18.0	21.9	28.3	32.1	37.0	38.7	45.2
– above three years	5.9	4.9	5.3	7.0	10.2	13.3	18.8
Share of foreign currency credit to							
– enterprises	30.6	34.5	33.0	27.6	29.3	24.6	22.5
– households	17.9	18.5	17.9	15.1	15.1	15.0	13.0

Source: CBR.

Despite the progress made in the early reform years, Russia's banking sector remains plagued by a large number of structural weaknesses; among the 28 countries assessed by the EBRD in 2008 Russia scored in the bottom half as regards banking sector liberalization. About 40 per cent of system assets are concentrated in the three largest state-owned banks. Unlike in eastern Europe, there is little prospect of privatizing a systemically important bank, and as a result only very limited potential for further entry by foreign institutions. The resulting lack of competition impedes the efficiency of the sector in intermediating funds. At the same time, the sector remains highly fragmented. The number of banks had only decreased to about 1,100 at the end of 2008, over half of which would fail to meet the minimum capitalization requirement that the CBR itself imposed on newly-registered institutions. Other weaknesses similarly cast doubt on the sector's resilience to future shocks. Many banks remain within financial-industrial groups, and in the absence of effective consolidated supervision it remains difficult to monitor lending to connected parties, and hence the true value of capital support. Enforcement of prudential standards by the central bank similarly remains weak. While acceptance into the deposit insurance system was conditional on meeting a number of prudential standards, institutions accounting for nearly all deposits were eventually admitted into the system.

Regulatory deficiencies in the sector were again underlined by the illiquidity problems that returned to the banking system since the autumn of 2007. These problems were clearly sparked by the USD 130bn net capital outflow from Russia in 2008, a sharp reversal from the three previous years of net inflows. Yet, doubts about banks' liquidity positions clearly accentuated perceptions of counterparty risk. This exposed a long standing vulnerability of the Russian banking system, but also the lack of prior reform steps that could have addressed this. Long term retail deposits, for instance, are not recognized as such under Russian law, and poor transparency in banks' published accounts certainly contributed to this widespread lack of trust.

5. The political economy of further financial reform

The development of Russia's financial sector is an interesting example of early, albeit piecemeal, regulatory reform that led to innovation and change led by private banks, with plenty of externalities in the rest of the economy. Ten years after the 1998 financial crisis the banking sector had become so sizable that various interest groups – representing regional banks, retail borrowers, or the aspiring middle class – began to lobby for reform.

Yet, by the end of 2008 Russia again faced an acute crisis of confidence and liquidity in the financial system. Most options of external financing had closed, domestic bond markets had become illiquid, and bank credit to the corporate sector was rapidly slowing. From October 2008 a wide range of anti-crisis measures were unveiled, consisting of both liquidity and capital injections, refinancing of corporate external debt, and more stringent requirements on minimum capital. The powers of the central bank were expanded to act as a lender of last resort, providing term credit without calling on collateral. A small number of failures by mid-sized banks had been resolved through acquisitions by state banks, but clearly the sector was heading for more significant consolidation.

Unlike at the time of the much more limited liquidity crisis of 2004, uncertainty in the financial sector is now coupled with broader uncertainty over macroeconomic prospects. As commodity prices decline and prospects for capital inflows to refinance the substantial external debt of Russian

enterprises and banks remained uncertain, the central bank engineered a substantial rouble devaluation. International reserves and savings of the oil windfall held by the government were rapidly diminishing, and resulted in the first downgrades in Russia's sovereign ratings in nearly ten years. Ongoing capital flight, and the higher risks from macroeconomic policies risked undermining these efforts aimed at stabilizing the banking sector.

Macroeconomic risk is clearly not conducive to further regulatory reform through the new presidential administration. The flight of deposits to the presumed safety of state banks, asset disposals by liquidity-constrained private banks, and acquisitions of private banks seemed set to expand the share of the principal state banks yet further. The future of mid-sized private banks in the imminent consolidation of the banking sector remained uncertain.

The adverse effect of banking sector instability on financial reform is indeed borne out by cross country empirical studies, such as in Abiad and Mody (2003). These studies find that banking sector crises mostly lead to reversals in reform, in particular due to the nationalization of banks, or due to government sponsored banking consolidation, which are typically combined with some market distortions that generate private rents.

As in most other areas, special interest groups have always been central to financial sector regulation in Russia. Shleifer and Treisman (2000) show that the banking sector lobby played an important role in shaping regulation and supervision during much of the 1990s. The governor of the CBR at the time, Victor Geraschenko, essentially represented the larger banks, not always the interests of the financial system as a whole and the rest of the economy, in his decision-making. Under his successor, Sergey Ignatiev (appointed in 2002), the CBR has become much more consistent in its support for reform. Yet, efforts to consolidate the sector are likely to come under challenge from special interests.

On the other hand, the much larger role of the banking sector, in particular in funding consumption of the growing middle class, now forces the authorities to accord much greater prominence to regulation and stability in the banking sector. The increased attention and the broader political support for the sector make it more difficult for individual institutions or subsectors of the financial system to pursue special interests. At the same time, the increased overall importance of the financial system to the economy is increasingly taken into account. For example, when large parts of the banking system came under pressure from the turmoil in international credit markets in the fall of 2007,

a range of measures were adopted by the CBR and the government to secure the liquidity of the sector, even though this clearly aggravated the inflation problem that was becoming an increasingly pressing social concern at the time.

Recent growth has created a constituency that will seek to sustain financial sector growth, and private institutions, even if the appetite of the government for further reforms does not strengthen. Initial reforms started a process that may now feed on itself: competition in the financial sector, along with slightly greater foreign participation stimulated innovation and expansion of credit into new areas. This process is supported by private institutions designed to safeguard this sector (for instance private rating agencies that prompt corporate governance reforms).

6. Conclusions

Does the Russian experience offer any insights into the relationship between financial development and growth? A first observation is that Russia's recovery from the 1998 crisis clearly preceded the subsequent expansion in private sector credit. The steep real depreciation, the reserves in capital utilization that were freed up by a deep recession, and, later, the boost through international commodity prices all sustained this growth until about the third quarter of 2008.

Second, banking credit to the corporate sector still only accounts for a relatively minor part of fixed investment funding. The sectors that saw sharp increases in investment and now account for the bulk of capital spending, predominantly benefited from abundant internal cash flows, or benefited from public support or ownership.

Third, the changing composition and nature of bank credit has clearly been important in alleviating credit constraints, and in reducing risks on the balance sheets of corporate borrowers. The extension of maturities (which still remain very short), the move out of dollar credit, and the move by banks into SME lending and lending in the regions, all clearly benefited productivity growth and corporate investment in more dynamic sectors.

Fourth, Russia's credit boom has been fuelled by both the highly favourable macroeconomic environment following the 1998 financial crisis, and a set of reforms aimed at better contract enforcement and at the integrity of the financial sector. Regulatory reforms following from the Gref Program of 2001 strengthened the financial system. Since then, change has increasingly been led by the private sector itself, not by the authorities.

Fifth, Russia's endemic weaknesses in the rule of law and lack of support for markets and accountable institutions still undermine the credibility of financial sector regulation. Populism directed at key institutions, such as the central bank, and regulatory interventions against private banks remain a threat. Strong growth of the period 200–2008 has created favorable conditions for financial development, though at the same time weakened incentives for further economy-wide reforms. The Russian public stands out among other transition countries for showing extremely limited trust in public institutions, the market economy, and in financial institutions specifically (EBRD (2007)). Memories of two financial crises are still fresh. Yet, the expansion of financial services into consumer credit and mortgages has begun to shift attitudes.

The authorities' response to the liquidity and confidence crisis of 2007–08 has been appropriately resolute. State banks, the last remaining pools of liquidity, are likely to expand their role and market share, possibly as the poles of sector consolidation. This may avert system-wide distress, though will undermine the banking sector's role in channeling funds to a more diversified Russian industry for years to come.

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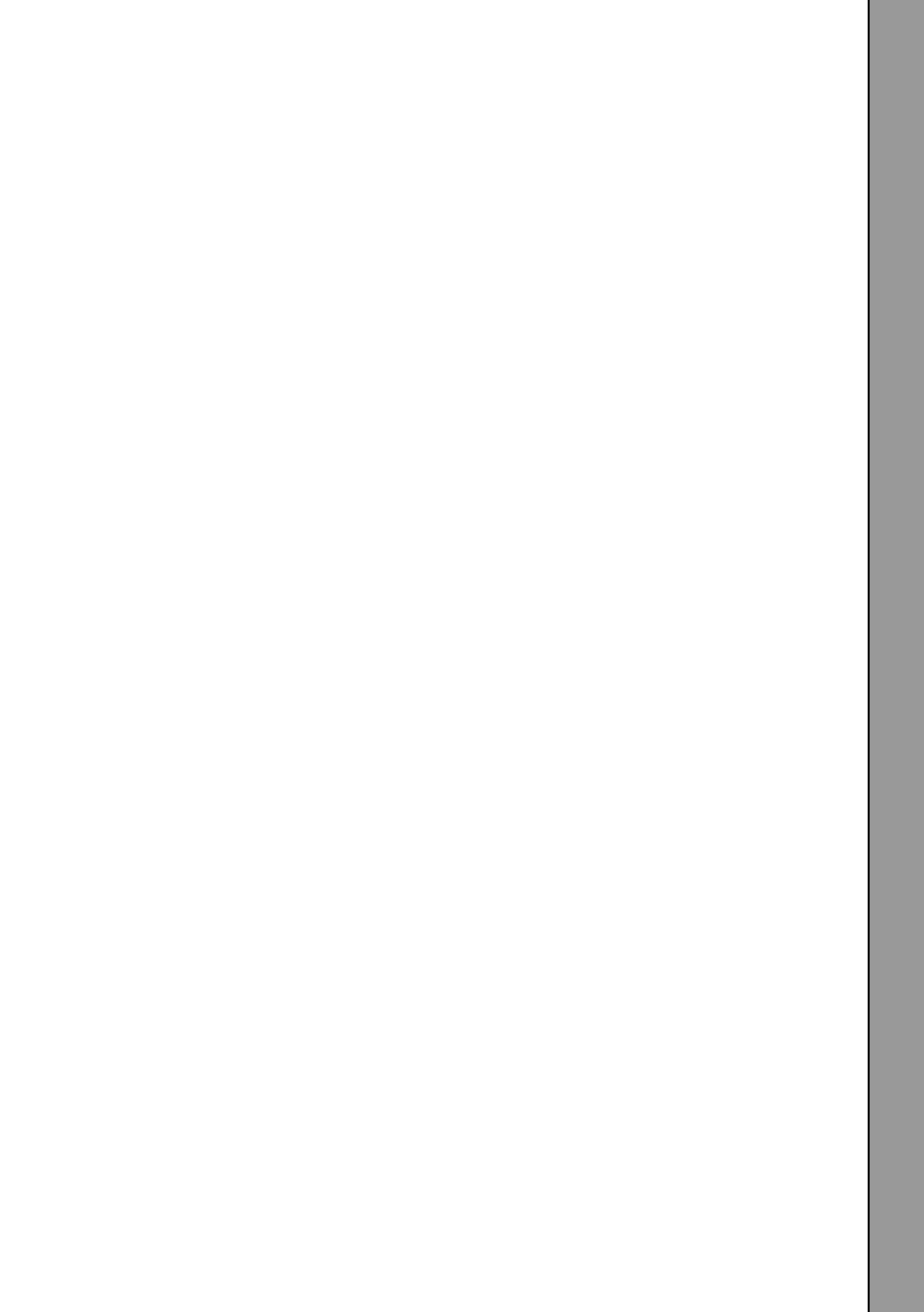

6. RUSSIAN FINANCIAL INSTITUTIONS AND THE OIL AND GAS SECTOR: FUNDING AND RECYCLING

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1. Introduction

After the collapse of the Soviet Union in 1990, the trend of the Russian economy was subject to a major trough. The 1998 crisis was translated into the growth rate of the Gross Domestic Product (GDP) which had been halved during this slump before bouncing back in a steady way up to 2008 at a level close to the level reached in 1990.

It could be assumed that the oil and gas activities would behave in line with the growth rate of the GDP. In fact the oil production declined dramatically from nearly 550 MT (11 M bblpd) a year in 1990 to 300 MT (6.1 M bblpd) a year in 1996 and recovered up to 490 MT in 2007 (9.9 M bblpd). The slackening of the oil production increase started in 2006 at a 2% level before levelling out in 2008 at –0.8%.

Conversely the gas production slightly decreased from 640 Bcm in 1990 to 585 Bcm in 2000 and increased to 650 Bcm in 2007. This rather stable trend conceals the decrease of 3 major gas fields (Yamburg, Urengoï and Medvezhe) which is offset by the launch of a new gas field of Zapolyarnoye at the Gazprom level and a steady increase from the Novatek and oil companies.

The allocation between domestic consumption and exports for both types of energy was quite different: the share of exports of oil grew from 52% in 1996 to 74% in 2007 whereas the share of exports of gas eroded from 37% to 33%.

These changes were partially influenced by the price moves since 1998: as a matter of fact the oil price touched down the bottom at USD 10 per barrel before reaching in the summer of 2008 the unexpected level of USD 140 per barrel. This entailed a major surge of the foreign currency reserves from the USD 10bn in 1998, to USD 596bn early August 2008. The gas sector did not benefit from this price increase as much as the oil sector due to the weighting of the domestic consumption which in addition was sold at a price well below the international price. It has to be borne in mind that the tax system through export duties has a distorting effect by giving a preference to gas production and oil refining at the expense of crude oil production.

As a result "the share of oil and gas in Russia's gross domestic product has more than doubled since 1990 and represents in 2007 above 30%. Income from oil and gas represented approximately 50% of Russian budget revenues and 60% of exports are coming from the oil and gas sector. The export duties generated sizable budget surpluses which were channelled into Government funds (USD 225bn as of the beginning of January 2009). Russia currently has two sovereign wealth funds after the former oil stabilization fund was split into the Reserve Fund (RF) and the National Welfare Fund (NWF). The funds were used to sterilise the liquidity effects of the external surplus.

It should not be forgotten that this manna did not contribute to diminish a very high energy intensity which amounts to 12–15 times the present level in the European Union. The banks involved in the energy sector were often primarily cash management entities within the so called "FIG" or Financial and Industrial Groups: Menatep was in the past the financial counterpart of Yukos, today disappeared, Petrocommerce is still linked to Lukoil, Gazprombank is a full member of the Gazprom group and Surgutneftegazbank is belonging to the Surgut group. In this context it is legitimate to wonder to what extent the nascent Russian financial institutions did contribute to the restoration and to the development of this strategic sector.

2. An environment conducive to external borrowing in an investment boom climate

The funding of oil and gas concerns both the funding of working capital and funding of capital expenditures. The working capital does not raise difficulties owing to its short term nature whereas the funding of investments supposes the raising of medium and long term financial resources.

The pattern of capital expenditures depends on the structure of the industry itself. On the one hand the oil industry has to invest in the upstream (exploration and production), the downstream (the refining) and the transportation (pipelines, terminals, railway fleets, tankers).

On the other hand, the gas industry relies on a more integrated approach: the transportation through pipelines is much less flexible than the LNG (Liquid Natural Gas) but still cheaper; the LNG implies a specific chain of liquefaction and of re-gasification with gas shipped by sea through gas carriers.

According to the "2008 Oil & Gas Yearbook" of Renaissance (29 July 2008), the capital expenditures programmes have experienced a very steep growth:

Table 1: Growth of Capital Expenditures Programmes (in USD bn)

	1999	2001	2004	2007
Oil				
– Upstream	2.3	6.8	9.0	21.7
– Refining	0.2	1.0	1.4	3.0
– Transportation	0.3	1.2	1.9	6.3
Total	**2.8**	**9.0**	**12.3**	**31.0**
Gas	2.8	5.7	9.7	19.4
Total	**5.6**	**14.7**	**23.0**	**50.4**

Source: "2008 Oil & Gas Yearbook" of Renaissance (29 July 2008)

This investment trend in the oil and gas industry is not driven by industrial growth itself , since the industrial growth is no longer driven by extraction industries but by manufacturing: the industry is reaching its full capacity and has to develop upstream and transportation in order to meet its future obligations in particular in the framework of long term contracts. This

movement is comforted by a record foreign direct investment (FDI) inflow of USD 27bn in 2007 of which 50% are devoted to extractive industries.

This accelerating pace of development in the capital expenditures in the oil and gas industry may be considered as an implicit reply to the continuous criticisms of the International Energy Agency, targeted in particular toward Gazprom which is considered preferring wrongly to invest on the downstream side rather than on the upstream side (Speech of Ambassador Ramsay in Brussels on January 31, 2008 at the French think tank IFRI conference "The External Energy Policy of the European Union")

This explosion of investment needs in the oil and gas industry entices to resort to external borrowing because mere development of the financial system does not enable it to respond efficiently to this surge of financial demand; even the rapid development of corporate loans in 2007 (142 bn USD) would have been insufficient to meet the oil and gas industry requirements: 35% (50/142).

The investment trend is present throughout the whole economy as the World Bank underlines it in its report on Russia June 2008, since the rate of growth is accelerating also in transport and communications (railways, pipelines etc.), in retail trade, in extraction of mineral resources (which is confirmed by the prior figures) and real estate.

Table 2: Fixed capital investment growth (in%)

Year	Growth
2005	+10.9%
2006	+16.7%
2007	+21.1%
2008 4M	+20.3%

Nevertheless "investment remains lower in Russia as a share of GDP (21%) than in other emerging market economies that have sustained high growth. Republic of Korea (38%), China (42%), and India (34%) all maintained significantly higher rates of investment over long periods (1980–2007)" (World Bank Russian Economic Report No. 16 June 2008 cf supra)

Moreover, several factors in the Russian environment are conducive to external funding which depends on several factors:

- the structure of the domestic banking industry itself, which cannot cover the funding deficit: the surplus of funding from individuals (deposits minus

loans) cannot cover the usual deficit of corporate companies (deposits minus loans) and brings about external borrowing, which is vindicated by the steady growth of the loan-deposit ratio from 110% in 2006 to 127% in 2008 (Jan-Aug) according to the World Bank Russia Economic Report No. 17 of November 2008. In addition, the prudential ratios limit the exposure to large counterparties (cf Instruction No. 110 of January 2004 ratios N6 and N7); the World Bank Country Director for Russia underlined in April 2008 in Vienna the high loan concentration: "the exposure to the five largest borrowers exceeds 50% of the capital for over half of the banking system in terms of both assets and number of banks"

- The situation in financial markets, which entails decisions based upon interest rate differentials and relative currency exchange rate variations: the rather low interest rate abroad and the appreciation of the domestic currency are two strong incentives to external borrowing; these parameters may be reversed by the deepening of the financial crisis in the autumn of 2008.

- The structure of revenues of borrowing companies, which can balance their currency position by matching currency revenues from exports with currency payments of principal and interest. (It does not solve the exposure of the balance sheet in absence of assets denominated in foreign currencies).

- The limitation of the currency position of banks, which fund themselves outside Russia and lend currency denominated loans to oil and gas companies which benefit from regular currency flows generated by exports (this situation may happen due to domestic interest rates in dollars which in the Summer 2008 were hovering around 8% up to 1 year versus 11% in rouble credits for the same maturity).

3. The capital needs are met by a double movement of external borrowing of banks and corporate companies

The banks which rely on a rather weak deposit base due to the concentration of household deposits within the state-owned banks (their share is much higher than their own share of total assets), have to borrow abroad largely.

It is worth being noticed that the two major state-owned banks (Sberbank and VTB) raised, partially abroad, in 2006 large amounts (USD 8bn each) through IPOs (Initial Public Offering) which have a favourable multiplier effect on the development of their loan portfolio in the framework of the new Basel II requirements. The state-owned oil company Rosneft refinanced the acquisition of Yukos assets in June 2006 by launching a USD 11bn IPO overseas.

3.1. Macroeconomic approach

The banking sector was little involved in the international markets up to 2003 and later resorted to both the Eurobond market and the syndicated loan market extensively: over the 1999–2007 period the gross borrowing amount was USD 167bn with a concentration of USD 149bn on the 2004–2007 period which is translated into a long currency position of USD 118bn at the end of 2007. The net variation is USD 90bn with USD 83bn in the 2004–2007 period. The 1st semester 2008 was more hesitant: for the first time in 5 years there was a capital outflow during the first quarter of 2008 (USD 10bn on a net basis) which was reversed in April 2008 with an inflow of USD 20bn. During this period only the syndicated loan market was open and the Eurobond market benefited from a "return in force" during the second quarter according to the last mission of the IMF in June 2008 in Moscow which nevertheless mentions a shift from the Eurobond market to short-term syndicated loans.

The corporate sector relied more heavily on the international markets than the banking sector with a similar emphasis in the 2004–2007 period: the gross borrowing amount over the 1999–2007 was USD 325bn with a concentration of USD 282bn on the 2004–2007 period. The net variation (without the net errors and omissions) amounted to an outflow of USD 22bn over the 1999 – 2007 period with an inflow of USD 33bn on the 2004–2007 period; in

the 1st quarter of 2008 there was a net outflow of USD 7bn and a net inflow of USD 13bn in April 2008.

Due to the growth of the former Stabilisation Fund, a considerable part of the public external debt was repaid after 2004. Consequently, the private external debt became more dominant. At the end of 2007, approximately ⅓ was owed by banks and ⅔ owed by corporates.

Table 2: Net Capital export/import by Private Sector (in USD bn)

		1999–2007	(2004–2007)
Banks	Gross	167	(149)
	Net	90	(83)
Corporates	Gross	325	(282)
	Net	–22	(33)

Source: CBR Statistics "Net Capital export/import by Private Sector"

On the banking side, Renaissance Capital (23.09.08) states that "the dependence on external funding is largely overestimated": the share of foreign liabilities in the total assets amounts to 18% in the first half of 2008 in comparison with the Kazakh banks which have carried out 44% of total funding in foreign liabilities. Moreover this share increased rather slowly over the last two years: from 14.6% in January 2006 to 18.3% in July 2008.

On the corporate side, a recent study of the European Bank for Reconstruction and Development entitled "Sustaining Russia's Growth: The Role of Financial Reform" reports that "the share of new investment financed through bank credit had gone only marginally up to 12 per cent" in 2007.

A brutal reversal of capital inflows happened during the 4th quarter of 2008 with –130 bn USD which corresponds to the total figure for 2008 (press release mid January 2009) and has to be compared with a positive figure of +83 bn USD in 2007. Such a change entails a full reassessment of the funding policy of the whole sector of oil and gas, bearing in mind that the external debt maturing in 2009 amounts to around USD 100bn. (World Bank Russia Economic Report No. 17 November 2008)

3.2. Microeconomic approach

The reconciliation with individual corporate company figures is attainable, given the concentration in the sector. The major players in the oil industry are: Lukoil, TNK-BP, Rosneft, Surgutneftegaz, Gazpromneft, Tatneft which represent 77% of the oil output in 2007; Gazprom dominates the gas sector with 84% of the gas output, Novatek produces 4%, the oil companies 9% and the independent companies, the remainder.

From the review, it can be derived that the companies are funded mainly in foreign currency by foreign based entities (only the agents of credits are identified for the Gazprom group which seems to be funded in foreign currency for more than 90%):

Table 3: Capital expenditures (Capex) programmes (in USD bn)

	2004	2005	2006	2007	2008 (restated July 08)
Gazprom (RAS)					
Capex	8.4	9.9	15.6	20.0	22.6***
Borrowings**	17.4	27.4	28.9	46.3	
Lukoil (US GAAP)					
Capex	3.4	4.2	6.9	9.4	
Borrowings**	3.9	5.0	6.2	7.0	
Rosneft (US GAAP)					
Capex†		1.9	3.5	6.2	
Borrowings‡**			13.8	27.3	
TNK-BP (US GAAP)					
Capex	1.8	2.5	3.5	4.4*	
Borrowings**	3.6	3.9	2.5		

† Excluding USD 17bn acquisition of securities in 2007
‡ Including 17 bn financing of acquisition of securities in 2007
* Proposed by BP and finally approved at the end of September 08 by Alfa Access Renova after a long dispute
** Long term and short term debt (from balance sheets)
*** Restated late September to USD 40bn (capex and long term financial) subject to approval of the Board of Directors

The financing is overwhelmingly in foreign currency and from foreign entities for more than 90%. “But the official statistics of the Central Bank of Russia

tend to overstate volumes of true foreign indebtedness as they include huge amounts of funds of Russian origin” (Renaissance January 2008)

Besides it is obvious that this dramatic effort of investment is only partially self financed by the internal cash flow, since net indebtedness tends to slightly increase over time for the major companies in spite of a rather modest dividend policy (except for TNK-BP which is also able to have a 40% dividend payout ratio)

The recent deepening of the economic and financial crisis changes the global reference: as a matter of fact, the 4 Russian “majors” (Gazprom, Rosneft, Lukoil, TNK-BP), the first two of them being state-owned, made, in a preemptive way, an official request for aid to the government mid-October 2008 in spite of a relative low weight of indebtedness (USD 70–80 billion), but in the framework of a large shrinking of their market capitalisation

It could be paradoxical to observe that a strategic sector is mainly financed by foreign entities in foreign currency. But the quality of the borrowers explains that their risk was much sought-after by the international bank community which already experienced a lasting cooperation over the last fifteen years.

4. A long history of cooperation between the foreign banking community and the Russian oil and gas industry

This cooperation took different forms over the years in accordance with the constraints of the day. It started with the classical oil trade finance centre in Geneva, Switzerland which uses the traditional instruments of short term financing: documentary credits, standby letters of credit, with sometimes some “postfinancing”.

The second step, on a medium term basis, was the pledging of long term export contracts in the gas sector (before and after 1998) which gave comfort to the banking industry, even though, at this time, the exporting company could have a theoretical weak financial structure (negative net working capital for example). The best example was the financing of the Offshore Section of the gas pipeline Blue Stream under the Black Sea between Russia and Turkey which was guaranteed by the pledge of a long term export contract between Gazprom and the Italian partner ENI, without involving at this stage the Turkish party (the used financing technique was export financing of equipment through buyers’ credits).

The improving situation of the Russian economy and of the oil and gas industry enabled the companies to tap the international markets (Eurobonds and syndicated loans), sometimes on an unsecured basis with thin margins.

A new financing scheme specific to the oil and gas industry is developing in Russia: the reserve base lending. This type of medium term financing, is derived from the well-known US technique and is provided by some foreign banks, which can afford teams comprising reservoir engineers able to appraise this particular risk. These teams have to be familiar with the Russian definition of reserves, which is different from the classical Western definitions established by the Society of Petroleum Engineers (SPE) and the US Security Exchange Commission (SEC), and with the Russian oil and gas environment. This type of financing is often coupled with equity funding and is more adapted to mid-size independent producers; but this financing does not seem to be widespread at the moment in Russia. The appraisal of the risk relies on the establishment of the frontier between the genuine exploration

based upon equity funding and the so called “first gas”, which can be financed through the Reserve Base Lending.

However the oil and gas industry is not yet in a position to secure a classical non recourse project financing, based only upon the future cash flows within the framework of a Special Purpose Vehicle, as it is common in Australia for example (a reinforcing of the applicable law seems to be necessary).

The skills of the financiers of the Russian oil and gas industry are quite acknowledged in the international financial community: as a matter of fact, the Russian companies took advantage very rapidly of the improvement of their own financial situation and of the general situation of the Russian economy: they lengthened the maturities of the financing, reduced the cost of financing and alleviated the weight of collaterals in a deliberate way.

5. The new catalysts in the financing of major projects are the oil and gas international “majors” or “sponsors”

At the beginning, the major projects were financed by the “majors” under the PSA framework (or Production Sharing Agreements) in the same way as the oil and gas projects in Kazakhstan and Azerbaijan: only three were signed in Russia:

1. Khariaga in the Timan-Pechora with Total

2. Sakhalin I with Exxon-Mobil

3. Sakhalin II with Shell 51%, Mitsui 24% Mitsubishi 20%
   (later Gazprom took 25%)

Under a PSA structure, the extracted oil is shared between the government and the concessionaire on the following basis:

- the "cost oil", covering for the repayment of cumulative costs spent in the project
- the "profit oil", shared by both parties, providing for their necessary return

But the government quickly made clear its opposition to this scheme, considering that the framework was detrimental to the interest of the state, which was not in a position to levy export duties applicable to companies operating out of the PSA scheme, in a period of unusually high price of oil, and was hurt by the overruns of the cost, deferring the return to a remote horizon.

The major projects are not financed mainly by International Financial Institutions (IFI): as a matter of fact the EBRD and the IFC from the World Bank Group prefer by far to finance capital expenditures on the demand side: energy saving programs (600 million euros by EBRD in September 2008 in terms of commitments) and limit themselves to the independent producers, the environmental projects and to the reduction of flaring.

The mere size of the major projects imply the cooperation with international partners or "majors", which can gather the additional financing, from international banks and domestic banks (generally state-owned), through a kind of project financing, which supposes the adjunction of some guarantees ; the examples of the 5 major projects of Gazprom underpin this situation:

<u>New Fields:</u>

1. Sakhalin II (25% owned by Gazprom,) the cost of which doubled from USD 9bn to USD 20bn; this project was partially financed recently by a consortium of banks led by the Japan Bank for International cooperation for USD 5.3bn in June 2008; the first deliveries of liquefied gas should start in 2009 toward Japan

2. Shtokman in the Barents Sea (51% owned by Gazprom) is at a less advanced stage: the partners are Total and Statoil and the cost lies in the range of USD 20bn (2000 estimate which may be increased to USD 50bn)

3. Yamal onshore field in Northwestern Siberia, likely to be developed by Gazprom on its own, at a cost which could be similar to the cost of the above offshore field (a meeting held at the end of September 2008 focused in particular, on the development of the Bovanenkovo field)

New Gas Pipelines

1. North Stream (51% owned by Gazprom) (under the Baltic Sea between Russia and Germany): the partners are two German companies and one Dutch company: BASF, Eon and Gasunie; the annual design capacity should be 55 bn bcm and the cost around USD 12bn

2. South Stream (51% owned by Gazprom) (under the Black Sea and through the Balkans) with ENI, which already participates in the Blue Stream between Russia and Turkey; the annual design capacity should be 30 bn bcm and the cost in excess of USD 20bn. This project is seen to be in competition with the Nabucco USD 8bn project from Turkey (in fact from Baku in Azerbaijan) which was originally supported by the European Union

These types of projects entail an international financing, including the domestic company, the international sponsors and international banks, accompanied sometimes by domestic banks (often state-owned), international financial institutions and export credit agencies . The giant feature of these projects is a genuine challenge for all the parties, and makes an exclusive domestic financing fairly unlikely.

The steep drop in the oil price, which took place in the 4th quarter 2008, has a direct impact on the projects incurring the highest marginal costs: in December 2008, the CEO of Gazprom’s Shtokman Development stated that the offshore Shtokman project “will remain economically viable with oil prices at about $50 or $60 a barrel”. Consequently it is likely that some projects of capital expenditures will be either deferred or simply frozen, as long as the oil price stays at an “unprofitable” level.

6. The so-called Raw Materials banks did not play a major role as "related parties" in the financing of their own groups.

These banks were already mentioned as members of oil and gas groups: Gazprombank (Gazprom), Petrocommerce (Lukoil), TNK-BP (Alfa Bank), Surgutneftegazbank (Surgut neftegaz) generally defend the policy of a growing independence vis-à-vis their groups. It is a deliberate strategy of Gazprom which plans to cut its stake in its banking subsidiary. The review of their "related parties" footnotes, in their audited reports, seems to confirm this assertion.

Gazprombank, which was in the past strongly related to Gazprom, states a link which varies between 19% (assets) and 28% (liabilities); Petrocommerce acknowledges a 23% (of total assets) relationship, Alfa Bank isolates its transactions with TNK-BP (around 10% of the total assets)

The recent deconsolidation of Gazprombank from the Gazprom Group in June 2008 highlights this trend toward a growing independence.

7. The challenges to overcome

The first challenge to banks in Russia lies in the development of net retail deposits (after deduction of retail loans) which are not sufficient to meet the net corporate loans needs (after deduction of corporate deposits). Even though the oil and gas industry is quite sought-after as a banking risk, it would be safer to leave open to the industry, a real choice between domestic and external financing sources. Obviously the trust of households has to be built up and the deposit insurance law contributes to it; it did not prevent a bank run against a well established private bank to be attacked by depositors in July 2004. In particular, term deposits must be developed and the law has to enshrine it.

The second challenge lies in the interest rates and in the rouble exchange rate: the differential in interest rates may shrink, in case of increases of interest rates in Western Europe (In 2008 it started to materialise by the doubling of spreads over LIBOR for syndicated loans over a one year period on the same maturities); the appreciation of the rouble may be slowed due to the pace of growth of imports, which is far beyond the pace of growth of exports: it is translated into a growing deficit of the non-oil current account. The reversal of the situation during the 4th quarter of 2008 due the oil price shock, the stop in capital inflows, the tightening of borrowing conditions and to the gradual devaluation of the rouble, changes thoroughly the financial environment of the oil and gas industry which has to turn itself to domestic funding with the help of the state.

The third challenge is the accelerating rate of inflation, which is going to slow the monetization of the economy and this would have a detrimental effect on the long term funding; the depressing effect on the exchange rate is at present offset by the appreciation of the rouble. The new situation of low oil price is choking off the creation of money because its major source, the external trade surplus, disappears.

The fourth challenge lies in the management of huge projects which are resorting to new technologies: LNG, deep sea drilling, pipelines in harsh conditions etc. But high marginal cost projects are likely to be postponed as a result of the fall in the oil price.

For the oil and gas industry, the challenge is to secure the means of financing of the upsurge of capital needs from a diversified basis; the strategic aspects are inevitable and will depend on the harmonious outcome of the energy dialogue between European Union and Russia. The state administration, in case of financial crisis, will step in with the sovereign funds as it was already contemplated in February 2008 for bridging the long term financing gap if needed.

8. Conclusions

Anyhow, the contribution of long term foreign financing to the development of the oil and gas industry, in addition to the financing from large state-owned banks seems to be inevitable to cope with the upsurge of capital expenditures in this industry, even though some “capex” programmes seem to be on hold at the beginning of 2009.

The recycling of funds is in fact done by the state through the two sovereign funds which tend to play a sterilisation role (the deposits in foreign currency are in fact benefiting to foreign banks, otherwise it would fuel the inflation with an accelerated growth of credit); these sovereign funds are benefiting from the levying of fluctuating export duties at increasing marginal rates above USD 20 per barrel, in correlation with oil price variations. Hence, there is no significant excess cash at the company level and no large asset management opportunities for Russian banks. Excess cash in the oil and gas industry abroad often generates political pressures and entails windfall taxes.

Nevertheless, Russian investment banks and brokers contribute to the financial intermediation, by arranging bond issues on the domestic market, advising on Mergers and Acquisitions, and launching IPOs (Initial Public Offerings) through their international network, present on different major international markets (London, New York) and these services are provided mainly to oil and gas companies.

In a nutshell, the Russian banking sector is striving to set up a balanced portfolio of loans, widespread throughout the whole economy, but this target is hampered by the very structure of the Russian economy still based:

- on the oil and gas industry (30% of the GDP),

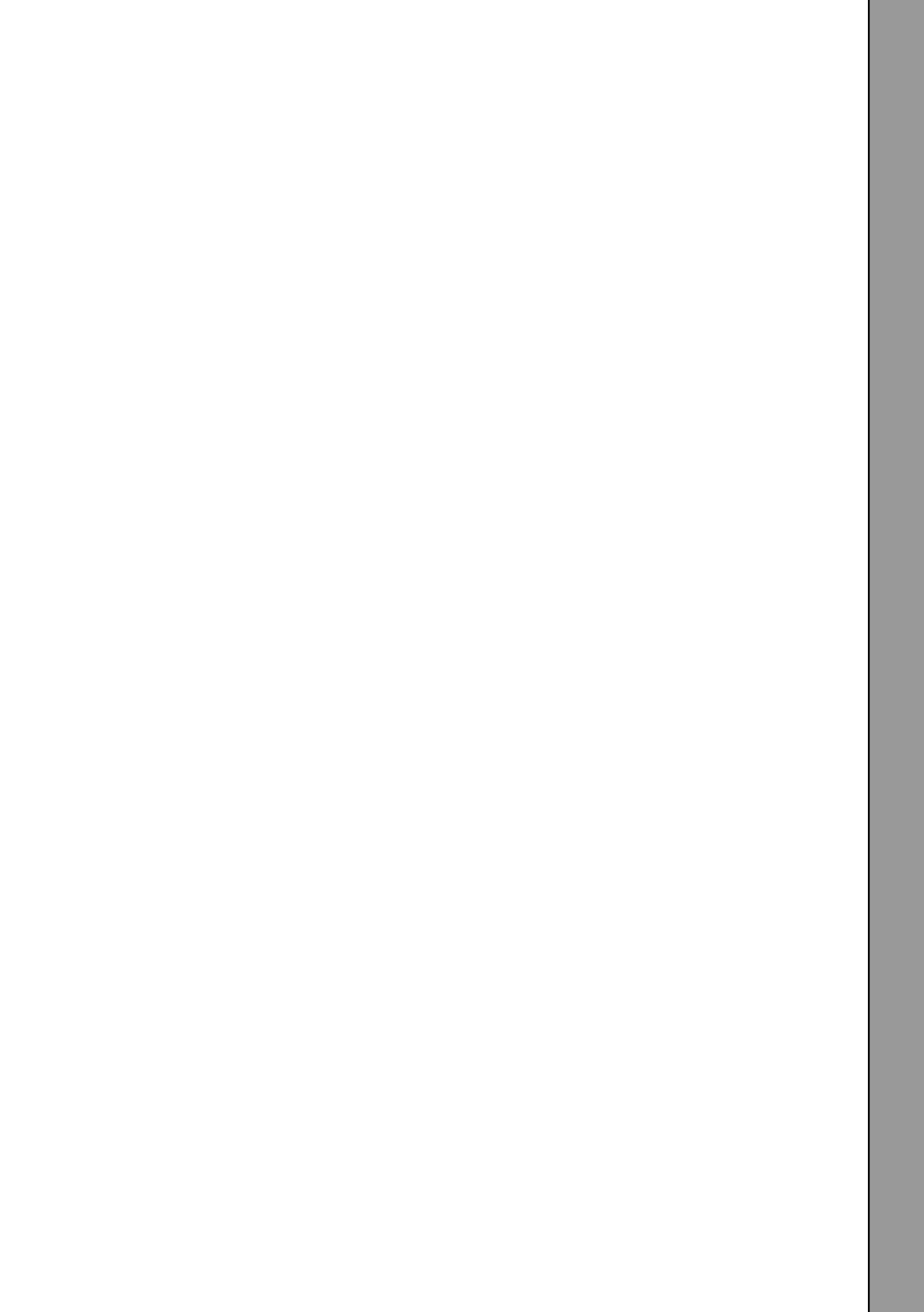
- on large Financial and Industrial Groups (FIGs) (12 groups which included oil and gas firms, were considered in 2006 as representing 60% of the GDP)

- and consequently on the small share of Small and Midsized Enterprises (12% of the GDP vs 40% in Poland)

This situation can be somewhat improved for Russian banks with the development of independents, either in the oil sector or in the gas sector in the coming years, as it is contemplated by the CERA consulting firm.

The feeling of international investors, international banks and international agencies (the International Energy Agency in particular) vis-à-vis the Russian oil and gas industry in the summer of 2008 is summarised by an article of Petroleum Economist in June 2008: "investors would prefer the companies to start spending upstream in Eastern Siberia to offset declining production in ageing fields in Western Siberia". In return the industry is hoping that the new government is going to ease the tax burden on Russian oil firms by removing the above mentioned distortions (as it started to be done with the modulating measures taxes according to differentiated oil and gas production conditions).

Up to now the Russian banking sector (either domestic or foreign) stayed in a rather neutral position vis-à-vis the Russian Government's oil and gas policy because it did not suffer directly from the tightening of this policy (cf. new law on strategic sectors) and from the recent conflicts with foreign entities, involved in the oil and gas industry. As long as the banks are fulfilling their original duties of lenders and intermediaries without playing the role of investors, their situation is not likely to change in an adverse way and in a near future.



7. RISK-TAKING BY RUSSIAN BANKS: DO LOCATION, OWNERSHIP AND SIZE MATTER?

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1. Abstract

The Russian banking sector has experienced enormous growth rates during the last 6–7 years. The rapid growth of assets has, however, contributed to a decrease in the capital adequacy ratio, thus influencing the ability of banks to cope with risk. Using quarterly data spanning from 1999 to 2007 on all Russian banks, we investigate the relationship between bank characteristics and risk-taking by Russian banks. The analysis of insolvency risk based on fixed effects vector decomposition provides us with three main conclusions. First, controlling for bank characteristics, bigger banks have higher insolvency risk than small ones. Second, foreign-owned banks exhibit higher insolvency risk than domestic banks and state-controlled banks are on average more stable. Third, we find that the regional banks engage in significantly more risk-taking than their counterparts in Moscow.

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2. Introduction

Banking sectors in most countries of the Commonwealth of the Independent states (CIS), Russia included, have experienced nearly phenomenal growth rates during recent years. As a consequence of the dramatically improved macroeconomic situation and important legislative changes, bank credit to the private sector in Russia has more than doubled since 2000 and exceeded 30 percent of GDP in 2007.

With the rapid growth of total assets, deposits and loan stocks, banks are increasingly assuming their role as financial intermediaries channeling household deposits and foreign borrowing into domestic corporate credits. This necessarily causes changes in the banks' assets and liability structures, attitudes towards risk-taking and risk management. Rapid credit growth is likely to increase (potential) banking sector risks. On the other hand, the ongoing financial deepening also indicates that the Russian banking sector is beginning to have an impact on private sector behaviour and investments. That is, banks in Russia, as well as in most other transition economies, are starting to look like banks elsewhere. They are by no means problem-free, but the challenges they need to tackle are similar to what banks in other emerging economies face. Given their growing role in economic development, surprisingly little is known about these banks' risk-taking behaviour.

The development of the banking sector in transition economies, as well as the financial sector in general, has been studied extensively. Barisitz (2008) and Bonin and Wachtel (2003) provide excellent recent overviews. Many studies focus on the effects of bank privatization on their performance (see e.g. Bonin et al. (2005a) and (2005b)), but until recently risk-taking by banks in transition has been a largely neglected area of research.

A handful of recent papers provide cross-country evidence on bank risk-taking in emerging economies. Maechler et al. (2007) examine the effect of various types of financial risks on the bank stability in 18 Central and Eastern European economies. Their results indicate that foreign banks tend to have a higher risk profile than domestic ones but there is no significant difference between the risk profiles of larger and smaller banks. Furthermore, credit growth relates to greater bank stability and only the acceleration of growth seems to add vulnerability. Haselmann and Wachtel (2007) use several accounting measures of bank risk to examine the risk-taking behaviour of

banks in 20 transition countries including Russia. Their results suggest that there is no group of banks with excessive risk-taking and that an unsound institutional environment leads to higher capital holdings and less credit risk-taking by banks.

To the best of our knowledge, no study on bank risk-taking has focused on Russia or any other CIS country. However, with its 1100 banking institutions, Russia in particular provides an extremely rich test case for analysing risk-taking. Furthermore, if Russia is to become a global financial centre, a goal clearly stated by, e.g., President Medvedev in spring 2008, we need to know much more about the behaviour of Russian banking institutions.

We use a large panel of practically all Russian commercial banks covering the post-1998-crisis period, from April 1999 to April 2007. In line with previous literature, we focus on the effects of bank size and ownership structure on bank risk-taking. Furthermore, we control for the location of the banks to see if Moscow-based banks, e.g. due to their better access to domestic and international interbank markets, differ in their risk-taking habits. Additionally, we examine the influence of what probably was the most important institutional change during the period, the introduction of a deposit insurance scheme, on the risk-taking of Russian banks.

In measuring risk-taking, we follow Maechler et al. (2007) in using z-score indicator to measure bank insolvency risk. This fairly simple measure produces valuable insights. First, risk-taking increases with size. Second, controlling for other bank characteristics, banking institutions located outside Moscow tend to bear higher risks. And finally, ownership does matter for risk-taking. Surprisingly, foreign-owned banks are on average found to be more risk-taking than others.

The next section provides a brief overview of the Russian banking sector. Section four describes the data and provides group-wise comparisons of financial risk measures by size and ownership categories and by location. Section five proceeds with the z-score analysis and section six concludes.

3. The banking industry in Russia

After the crisis-ridden 1990s, especially the deep recession and financial collapse of 1998, the Russian economy has grown annually by more than six percent since 2000. The banking system has experienced rapid growth since 2001, when the sector recovered from the insolvencies and the complete lack of trust created by the 1998 turmoil. The resulting financial deepening has been supported by a stable macroeconomic environment, increasing incomes and institutional reforms.

Continuous economic growth, rising real incomes, declining inflation and public sector surpluses have enabled fast increase in the private sector credit. The main funding base for the Russian banks are private sector deposits, which have indeed increased rapidly during the last decade. Also foreign borrowing has increased, even though the level of net foreign liabilities in Russian banks is still relatively modest at on average below 20% of total liabilities.

Table 1: Banking system indicators, % of GDP

	2004	2005	2006	2007	2008
Total assets	42.1	41.7	44.8	51.9	61.0
net foreign asset position	–1.4	–1.9	–2.7	–5.9	–9.0
credit to the private sector	20.2	22.8	25.2	29.9	37.2
o/w enterprises	18.3	19.6	20.3	22.9	28.2
o/w households	1.9	3.2	4.9	7.0	9.0
deposits by the public	23.6	24.4	27.3	32.0	37.0
o/w households	11.5	11.6	12.8	14.2	15.6

Note: Data concerns beginning of each period.
Source: Central Bank of Russia

Furthermore, a number of important institutional reforms have helped fuel banking sector growth. The most important one was the introduction of the deposit insurance system (DIS). The federal law on compulsory deposit insurance was adopted in December 2003. It made the formerly implicit guarantee of state-controlled banks explicit and outlined clear rules for banks entering the system. The Deposit Insurance Authority began its operations in 2004, and by the end of March 2005 the first 824 banks were admitted into the

system. Most of the rejected banks were small, as the banks already admitted accounted for 98 percent of household deposits[2].

During 2003–2005 several other important laws, e.g., clarifying the rules for mortgage lending and mortgage-backed securities, were enacted. The law from 2005 gave the framework for the operations of private credit bureaux (for more details see Barisitz 2008). These recent changes are also subject of the literature investigating the Russian banking sector. Its focus is on bank supervision and the introduction of the deposit insurance system (Camara and Montes-Negret, 2006; Vernikov, 2007; Claeys and Schoors, 2007), market discipline and deposit interest rates (Karas, Pyle and Schoors, 2009; Peresetsky, Karminsky and Golovan, 2007) as well as the efficiency of banks (Caner and Kontorovich (2004); Karas, Schoors and Weill, 2008).

During the last few years Russian banks have intensively diversified into household lending, especially mortgages, as well as lending to SMEs. Credit maturities have also increased. The volumes of mortgage lending are, however, still tiny. Another remarkable recent trend is the continuing de-dollarization of banking assets and liabilities. Like many transition countries, Russia was heavily dollarised and immediately after the 1998 crisis the use of dollars was very widespread. The share of foreign currency loans in corporate loans was below 25% in 2007.

In light of all these changes, the structure of the Russian banking sector has remained surprisingly unchanged. The large, state-controlled banks still dominate the market. Even though the number of banks has decreased from 1349 at the end of 1999 to 1136 by the end of 2007, the great majority of the banks are still tiny ones and can hardly be called banks. At the end of 2007 some 900 banks had the right to attract household deposits and only 300 banks had a general banking license. The foreign ownership share remained fairly limited[3]. The large number of small banks, regional fragmentation and minimal foreign participation have often been mentioned as the main hindrances to further banking sector reform and growth. In this paper we discuss the extent to which the characteristic features of the sector determine the risk-taking behaviour of Russian banks.

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[2] In order to pacify depositors during the mini-banking crisis of summer 2004, the government enacted a law granting temporary deposit insurance to all banks. Therefore, irrespective of possible inclusion in the deposit insurance system, all Russian banks were guaranteed blanket deposit insurance for deposits up to RUR 100,000 from July 2004 until the end of 2006 (IMF 2004).

[3] There were 202 banks with a foreign ownership at the end of 2007, 62 of them fully foreign-owned.

4. Data and the key variables

Our dataset covers the banks operating in Russia over the period of April 1999 – April 2007[4]. It consists of banks' quarterly balance sheets and profit and loss accounts. The data are provided by the financial information agency Interfax and originated in the Central Bank of Russia. For a more detailed description of the dataset used, see Karas and Schoors (2005). As the sample period starts in 1999, our results are not directly influenced by the financial crises of August 1998 or by the current crises which started in August 2007. The data constitutes an unbalanced panel, because there were banks entering and leaving the market due to mergers or failures. A brief overview of the main variables, their definition and summary statistics are provided in Table 2.

Table 2: Definition and summary statistics of the main variables

Variable	Definition	Mean	St.Dev.	Min	Max
Logarithm of assets	total assets, RUB million	6.27	1.77	2.66	15.06
Liquidity ratio	ratio of liquid assets to total assets	0.31	0.17	0.03	0.85
Credit growth	annual change in loans to nonfinancial clients	0.66	0.94	-0.71	6.38
Loans to individuals	ratio of loans to individuals to total loans	0.14	0.17	0.00	0.98
Nonperforming loans	ratio of nonperforming loans to total loans	0.02	0.05	0	1
Capitalization	ratio of equity to total assets	0.26	0.16	0.05	0.93
Return on assets	profit before taxes to total assets	0.01	0.01	-0.01	0.07
State-controlled bank	bank included in the list of state banks by Vernikov (2007)	0.03	0.17	0	1
Foreign-owned bank	bank with foreign ownership share more than 50%	0.02	0.15	0	1
Moscow bank	bank's headquarters are located in Moscow	0.44	0.50	0	1

We use the book value of total bank assets as a measure of size. Bank size is especially important in Russia, where a handful of the largest banks account

[4] Vneshekonombank is excluded, since it is not a traditional commercial bank but a state development bank.

for significant part of banking sector assets. Due to more possibilities for diversification and better access to financial markets, large banks are often supposed to be less risky. Nevertheless, as Demsetz and Strahan (1997) point out, large banks offset their potential benefits from diversification with lower capital ratios and more risky loan portfolios. Also empirical evidence on the relationship between size and risk has produced slightly mixed results (Iannotta et al. (2007), Haselmann and Wachtel (2007)).

As for ownership, we distinguish among three ownership groups to determine majority ownership: state-controlled, foreign and domestic private banks. The foreign ownership dummy variable is based on the CBR data on foreign-owned banks. We define a bank to be foreign-owned if the foreign ownership share in its assets exceeds 50%. State-controlled banks are defined using the list provided in Vernikov (2007)[5].

Ownership may be important for risk-taking behaviour for various reasons. State-owned banks are often assumed to take higher risks than the private ones. The underlying reasons differ according to one's view on the character of state-owned banks, see e.g. Sapienza (2004). Recent evidence from industrialised countries (DeNicolo (2001), Iannotta et al. (2007)) suggests that state-owned banks typically exhibit higher risk than other types of banks. Studies on transition economies have, however, produced mixed results (DeNicolo and Loukoianova (2007), Maechler et al. (2007)).

Foreign-owned banks may have a different risk profile due to less local expertise and fewer local connections compared to the domestically owned banks. Their operations may also be less risky since they might often be able to cherry pick the most creditworthy borrowers in an emerging market (Bhaumik and Piesse (2007)). Additionally, these banks can often rely on strong parent companies to provide them with access to better risk management techniques and possible diversification of country risk. On the other hand, foreign ownership may aggravate risks if parent banks tend to stress rapid credit growth in order to relieve tightening interest margins at home. Moreover, foreign banks are likely to be more sensitive to economic development in their home countries. As evidenced by the recent crisis that may not always increase the stability of local markets.

[5] This list largely overlaps with the other lists of state-controlled banks used by Karas et al. (2008). Moreover, our number also corresponds to the number of government-controlled banks in the Central Bank Supervision Report (2006).

Foreign bank entry has been one of the decisive factors shaping banking sector development in Central and Eastern European transition countries. Furthermore, there is a growing literature exploring the effects of the presence of foreign-owned banks on domestic credit markets in emerging economies[6]. The role of foreign-owned banks in Russia has been dramatically different from those in the Central European banking sector. The share of foreign capital in the Russian banking sector was tiny up until spring 2007 as no major privatizations had taken place. Nevertheless, the foreign-owned banks operating in Russia may be extremely important as a benchmark for domestic ones and it is therefore most interesting to examine if they differ in their risk-taking. Recent studies on transtition countries provide evidence of higher risk profiles for foreign-owned banks (DeNicolo and Loukoianova (2007), Maechler et al. (2007)).

The division by ownership and size is rather standard. A bank's location within a single country is clearly more specific to Russia. Economic developments in different parts of Russia vary a lot. About half of the Russian banks are located in Moscow. The other half, located in the other regions of the Russian Federation, are mainly small banks constituting only 15% of the total banking sector assets. It has been occasionally argued that regional banks are more inclined to lend to local enterprises and to small and medium-sized businesses, thereby promoting growth more than Moscow-based banks. Moscow-based banks, on the other hand, are more active in interbank money markets. If true, this should also be reflected in differences in risk measures. It may also be true that the quality and strength of bank supervision differs between Russian regions.

Therefore we distinguish between the location of the bank's headquarters in Moscow or elsewhere in the Russian Federation. We are fully aware that many banks have major operations outside the region where they are officially registered. Based on the above discussion we hypothesize that banks registered in Moscow behave differently either because their clients are different or their main operations are different or because bank supervision is different.

Russia adopted a deposit insurance system in 2004 with the majority of banks screened and admitted into the system by end-March 2005. The Russian data offers us a unique opportunity to test whether the introduction of a deposit insurance system affects bank risk-taking in the short run. We create a dummy

[6] Mostly the results on the benefits of the foreign bank presence are mixed. See e.g. Giannetti and Ongena (2008).

variable indicating if the bank was included into the system in the “first wave”, by end-March 2005. Inclusion of the banks in the deposit insurance system is defined using the information from the Russian Deposit Insurance Agency.

There is no single, universal measure that could be used to assess risk-taking behaviour by banks. Therefore, before moving to the z-score approach, we also tested the significance of the differences in financial risk ratios among different subgroups of banks. We found that private domestic banks have consistently higher capitalization levels than either state-controlled or foreign-owned banks. Further, analysis of the credit risk uncovers that foreign-owned banks as well as Moscow-based banks always exhibit lower levels of nonperforming loans to total loans than other types of banks. Those two types of banks also tend to have higher levels of liquid assets to total assets[7].

All in all, the analysis of ratios measuring financial risk confirms significant differences among groups of Russian banks by size, location and ownership. Nevertheless, it is only based on the comparisons of unconditional medians. The following regression analysis provides more insight by uncovering also conditional correlations.

7 We use a nonparametric K-sample test on the equality of medians. For detailed discussion and descriptive statistics of all the risk measures see Fungacova and Solanko (2008).

5. Measuring risk - bank insolvency risk (z-score)

5.1. Methodology

We employ a measure for insolvency risk developed by Boyd and Graham (1988) [8] that has been increasingly used in the banking literature. Different modifications of z-scores have been applied in the empirical cross-country (De Nicolo (2001); Boyd et al. (2006); De Nicolo and Loukoianova (2007); Maechler et al. (2007); Iannotta et al. (2007)) as well as single-country studies (Konishi and Yasuda (2004); Lin et al. (2005)).

The insolvency risk measure ("z-score" hereafter) is a statistic indicating the probability of bankruptcy (bank failure). The z-score for each bank *i* at quarter *j* is calculated as:

$$Z_{ij} = (ROA_{it} + EQTA_{it}) \,/\, \sigma(ROA)_{it} \qquad (1)$$

where ROA_{it} and $\sigma(ROA)_{it}$ are sample estimates of the four quarters moving average and the four quarters standard deviation of bank *i'*s returns on assets at quarters *t* to *t-3* and $EQTA_{it}$ is the four quarters moving average of the equity capital to assets ratio. A bank's return on assets is calculated as its one-quarter profit before taxes on the quarter's average total assets. A bank's equity to assets ratio is calculated as the equity capital on total assets at the end of a given quarter. As we used the four quarters (backward-looking) moving averages in constructing our insolvency measure as well as explanatory variables, the time span of our analysis effectively covers the years 2000–2006.

Statistically speaking, the z-score represents the number of standard deviations returns would have to fall in order to deplete a bank's equity. A higher z-score corresponds to a greater distance to equity depletion and therefore to lower risk and higher bank stability.

The z-score measure inherently depends on the assumption that the ROA, relying on profit and loss data, gives a useful approximation of a bank's financial health. Since our data is based on Russian accounting system standards, which stress formal reporting rather than economic meaning, it may be questioned whether our data fulfils that requirement (Barisitz (2008)). Nevertheless, as we

[8] This measure originated as a predictor of corporate bankruptcy (Altman, 1968).

only compare Russian banks with each other, possible flaws in the accounting standards should not be over-emphasized. Moreover, we use the z-score indicator to uncover statistically significant conditional correlations, not causality.

Our focus is on the effects of a bank's size, ownership and location on measures of risk. The bank's size is measured by a continuous variable (logarithm of total assets) whereas ownership and location are proxied by using corresponding dummy variables as defined in the previous section. The dummy variables for ownership and location exhibit very little if any within variation and the dummy variable for inclusion in the deposit insurance scheme is fully time-invariant. Therefore a standard fixed-effects model is likely to lead to inefficient estimates with very large standard errors. In addition, we also include set of bank specific control variables in our regressions.

We use the fixed effects vector decomposition (FEVD) approach by Plümper and Tröger (2007) to solve the problem of time invariant variables[9]. The approach suggests estimating the model in three steps. First, our dependent variable is regressed only on the cross-section fixed effect and the time-varying factors i.e. size and a set of control variables. Second, the estimated fixed effect (unit effect) is decomposed into the part explained by the time-invariant variables and the unexplainable part (error term). Finally, the model including the unexplained part of the fixed effect is re-estimated by pooled OLS. By design, the remaining error term is no longer correlated with time-invariant variables. Plümper and Tröger (2007) show that FEVD estimates are superior (in root mean squared errors) to the traditional fixed effects estimation. In running the FEVD estimations, we use STATA's FEVD module.

We estimate the following model:

$$risk_{it} = \alpha_i + \beta_1(size)_{it} + \beta_2(owner)_i + \beta_3(region)_i + \beta_4(DepInsurance)_i + \\ + \beta_5(IA)_{it} + \beta_6(BankSpec)_{it} + \beta_7(dummy)_t + \varepsilon_{it} \quad (2)$$

where

risk is the measure of risk (z-score ratio) for bank *i* at time *t*
size stands for the logarithm of total assets of bank *i* at time *t*
owner is a set of dummy variables distinguishing among foreign-owned, state-controlled and domestic private banks
region is a dummy variable indicating Moscow headquarters of bank *i* at time *t*

[9] This approach has already been used in the labour literature, see e.g. Amable et al. (2007).

depInsurance is a dummy variable indicating inclusion in the first wave of the deposit insurance system
IA is a set of interaction dummy variables between a bank's size and bank-specific factors
bankSpec is a set of bank *i'*s specific *ratios* at time *t* including liquidity, credit growth and the share of loans to individuals in total loans
dummy stands for year dummy variables

All the variables used in the regressions are four-quarter moving averages. Z-score and total asset variables are in natural logarithms. Bank-specific factors include credit growth, the ratio of liquid to total assets and the share of loans to individuals in total loans. A bank's size, ownership, location and inclusion in the first wave of the deposit insurance system are defined as described in the previous section. Table 2 in section 4 gives details of the variables used in the regressions.

5.2. Estimation results

5.2.1. Z-score

In order to analyse the relationship between a bank's size, ownership and location and the risk measured by the z-score, we estimate the model of equation (2) employing the fixed effects vector decomposition described above. The results are shown in Table 3 below. The first column reports the regression results from a basic model that does not include interaction dummy variables. In the second column model is augmented by including interaction terms of bank's size with ownership, credit growth and liquidity.

Several interesting findings emerge. First, the results consistently indicate that larger banks have significantly lower z-scores and thus higher insolvency risk. This confirms that large banks can indeed bear higher risks. Second, somewhat unexpectedly, foreign-owned banks bear higher insolvency risk than domestic private banks. This result is fully in line with some earlier studies on emerging economies using z-scores as the risk measure (Maechler et al., 2007). The result reflects the limitations of the risk measure used, as it partly originates from the lower capitalization ratios of the foreign banks especially in comparison to domestic private banks. Nevertheless, the positive sign of estimated coefficient for the interaction between bank's size and foreign ownership indicates that bigger foreign-owned banks are more stable than smaller ones. Since the majority of

foreign banks in Russia are small, the estimated coefficient for the foreign-owned banks in the basic model is negative. The overall effect of state ownership on a bank's insolvency risk is positive, i.e. state-controlled banks tend to be more stable. To investigate this result more closely, we add the interaction term of size and state control in the second specification of our model. This interaction is positive and highly significant. At the same time, the estimated coefficient for the state-controlled dummy variable becomes negative. This indicates that state-controlled banks are similar to the foreign ones in that the large banks are more stable than small ones. In the case of state-controlled banks, however, the large banks prevail and influence the sign of state dummy variable in our basic model.

Third, the Moscow-based banks are always more stable than the regional banks. It is necessary to keep in mind that we differentiate between Moscow and regional banks only based on the location of their headquarters and not the activities of a bank in certain regions. Location of the headquarters can however also be influenced by e.g. possible differences in regulation in regions. Participation in the deposit insurance scheme does not matter for bank's stability, at least not during the period of time that we investigate.

Table 3: Estimation results

	BASIC MODEL		INTERACTIONS INCLUDED	
SIZE, OWNERSHIP AND LOCATION				
Size (total assets)	***	–0.241	***	–0.289
State–controlled bank	***	0.283	***	–0.703
Foreign bank	***	–0.298	***	–0.854
Moscow–based bank	***	0.491	***	0.496
CONTROL VARIABLES				
Loans to households (prop. of loans)	***	–0.306	***	–0.326
Liquidity (liquid to total assets)	***	–0.539	***	–0.641
Credit growth	***	0.035	***	–0.158
Deposit insurance		0.007		0.015
INTERACTIONS				
Size and liquidity				0.020
Size and credit growth			***	0.032
Size and state–controlled			***	0.128
Size and foreign owned			***	0.070
Number of observations		25,513		25,513
Adjusted R^2		0.400		0.402

Note: The table contains results for the FEVD regression. We report estimated coefficients as well as their significance (***significant at 1%, ** significant at 5% and * significant at 10%). Year dummy variables and a constant term are included but not reported.

Finally, we conclude that the bank-specific characteristics that we use as control variables do play a role in explaining insolvency risk. In line with earlier literature (e.g. Maechler et al. (2007)), we find that higher liquidity implies higher insolvency risk. The interaction dummy variable confirms that the role of liquidity does not depend on bank's size. The growth of a bank's loan stock is used to control for the credit risk. In line with Maechler et al. (2007), its impact is positive in our estimations and this indicates higher stability. We also control for the interaction of bank size and credit growth to see if credit growth affects small banks differently. We find that large banks with high credit growth are in fact more stable and for the other banks higher credit growth is connected to lower stability.

We test the robustness of our empirical results using several techniques.

First, the results are robust to the exclusion of the three largest state-controlled banks (Sberbank, Gazprombank, VTB) from the sample.

We split the sample into Moscow-based and regional banks. The basic model is run for the two subgroups separately. Results for both subgroups are in line with the results of the basic model reported above.

A modification of our basic model that includes lagged explanatory variables (size, credit growth, the share of loans to individuals and liquidity ratio) is also considered. Indeed, the impact of these variables on bank's stability might take time and be visible only in the following periods. The signs and significance of the estimated coefficients in the basic model however do not change when one and four period lags are considered.

We also use an alternative definition of foreign-owned bank when foreign ownership share is 20% and more. The results of the main model do not change either.

5.2.2. Z-score components

The z-score measure consists of three main components: the return on assets, capitalization and the volatility of the ROA. In order to investigate the contribution of each of them to explaining differences in the banks' stability, we run our basic model using all of these components as a dependent variable. We report the results of the z-score component regressions in the following, Table 4.

The first component of the z-score measure is capitalization[10]. In this case, the fit measured by R^2 is the highest of all the z-score components. The estimated coefficients are larger than for the other z-score components and almost all of them are significant. The estimated coefficients are mostly in line with the results of the main model, which indicates that the majority of the main results are driven by the contribution of the capitalization ratio. Larger banks have lower capitalization and this result undoubtedly drives our final result that banks with a higher amount of total assets are in general less stable. State-controlled banks are in general better capitalized whereas foreign owned ones have lower capitalization than private domestic ones.

More liquid banks have lower capitalization, which indicates that banks substitute between liquidity and solvency risk. Nevertheless, liquid large banks tend to have higher capitalization. The effect of deposit insurance participation on capitalization is significantly negative. Banks in the deposit insurance system do seem to substitute deposit insurance for capital, or put in other words, take more risks for the same level of capital. This result is in line with earlier literature (Demirgüc-Kunt and Kane, 2001).

[10] Capitalization is, similar to the calculation of the z-score, calculated as the four-quarter moving average. The other z-score components, the ROA and volatility of the ROA, are calculated in the same way.

Table 4: Z-score component regressions

	CAPITALIZATION		ROA		VOLATILITY OF ROA	
	Estimated coefficient					
SIZE, OWNERSHIP AND LOCATION						
Size (total assets)	***	–0.078	***	0.001	***	–0.0002
Foreign bank	**	–0.030	***	–0.003	***	0.004
State–controlled bank	***	0.022	***	0.011	***	0.005
Moscow–based bank	***	0.126	***	–0.003		–2.80E–05
CONTROL VARIABLES						
Loans to households (in total loans)	***	–0.078	***	0.003		0.0002
Liquidity (liquid to total assets)	***	–0.234	***	0.010		–0.0001
Credit growth	***	–0.008	***	0.001	***	0.0006
Deposit insurance	***	–0.014	***	0.001	***	–0.0002
INTERACTIONS						
Size and liquidity	***	0.009	***	–0.001		–0.0001
Size and credit growth	***	0.001	***	–0.0002	***	–0.0001
Size and foreign–owned	***	0.012	***	0.001	***	–0.0002
Size and state–controlled	***	0.006	***	–0.001	***	–0.0006
Number of observations		25,513		25,513		25,513
R^2		0.786		0.526		0.458

Note: The table contains estimation results of the model described above for different z-score components. We report the estimated coefficients as well as their significance (* significant at 10%, ** significant at 5% and *** significant at 1%). Year dummy variables and constant included but not reported.

The second column contains results for the regression with the ROA as the dependent variable. Similar to the capitalization component of the z-score, almost all the estimated coefficients are significant for the ROA. However, the majority of their signs differ from the results in the main z-score regression. When accounting for a bank's ownership, state-controlled banks have a significantly higher ROA than domestic private ones. Large state-controlled banks are, however, less profitable. Foreign banks, on the other hand, are less profitable, the exception being only large foreign banks. Moscow-based banks are in general less profitable.

The last component of our risk measure is the volatility of the ROA as measured by the standard deviation. Most of the estimated coefficients in this regression are significant but have a different sign than the results presented in our main model. They are also lower in absolute values and therefore, unlike the measure of capitalization, they contribute less to the main results. Thus, the analysis of the z-score components indicates that the differences in the risk profiles of banks are mostly driven by the differences in capitalization.

6. Conclusion

Favourable macroeconomic conditions and important regulatory reforms have backed the rapid growth of Russia's banking sector during this decade. As the economy is increasingly monetized, the role of banks and other financial intermediaries in supporting the continuous growth of investments and private consumption is gaining more importance. Therefore the stability of the banking sector is even more crucial. The Russian banking sector is still rightfully characterized as small, regionally fragmented and dominated by a few large state-controlled entities.

In this paper we use a unique bank-level dataset on all Russian banks to examine how risk varies with a bank's size, ownership and location. The main objective is the detailed examination of how these various groups of banks differ in their attitudes to risk. We employ regression analysis using a z-score measure of bank insolvency risk. Controlling for bank characteristics, large banks in Russia have higher insolvency risk than small ones. Second, in line with the previous literature on emerging economies, foreign-owned banks exhibit higher insolvency risk than domestic banks. Even though the foreign bank presence may in general greatly increase banking sector efficiency and widen the range of banking services available, foreign-owned banks in Russia seem to bear higher risks. Interactions that are also included in our model however point out that there exist differences in attitudes towards risk between large and small foreign banks. Large ones are on average more stable. State-controlled banks are on average more stable than the private domestic banks. Similar to the case of foreign banks, large state-controlled banks are more stable than the others.

Third, we find that the regional banks are significantly more prone to risk-taking than their counterparts in Moscow. Regional banks only account for a small fraction of the total banking sector assets, thus this finding should not be alarming for the banking sector as a whole.

All in all, factors similar to those in emerging European economies seem to explain the levels of insolvency risk in Russia. We also briefly examined if inclusion in the Russian deposit insurance scheme has influenced a bank's insolvency risk. The results are mixed and further research on this topic is clearly needed.

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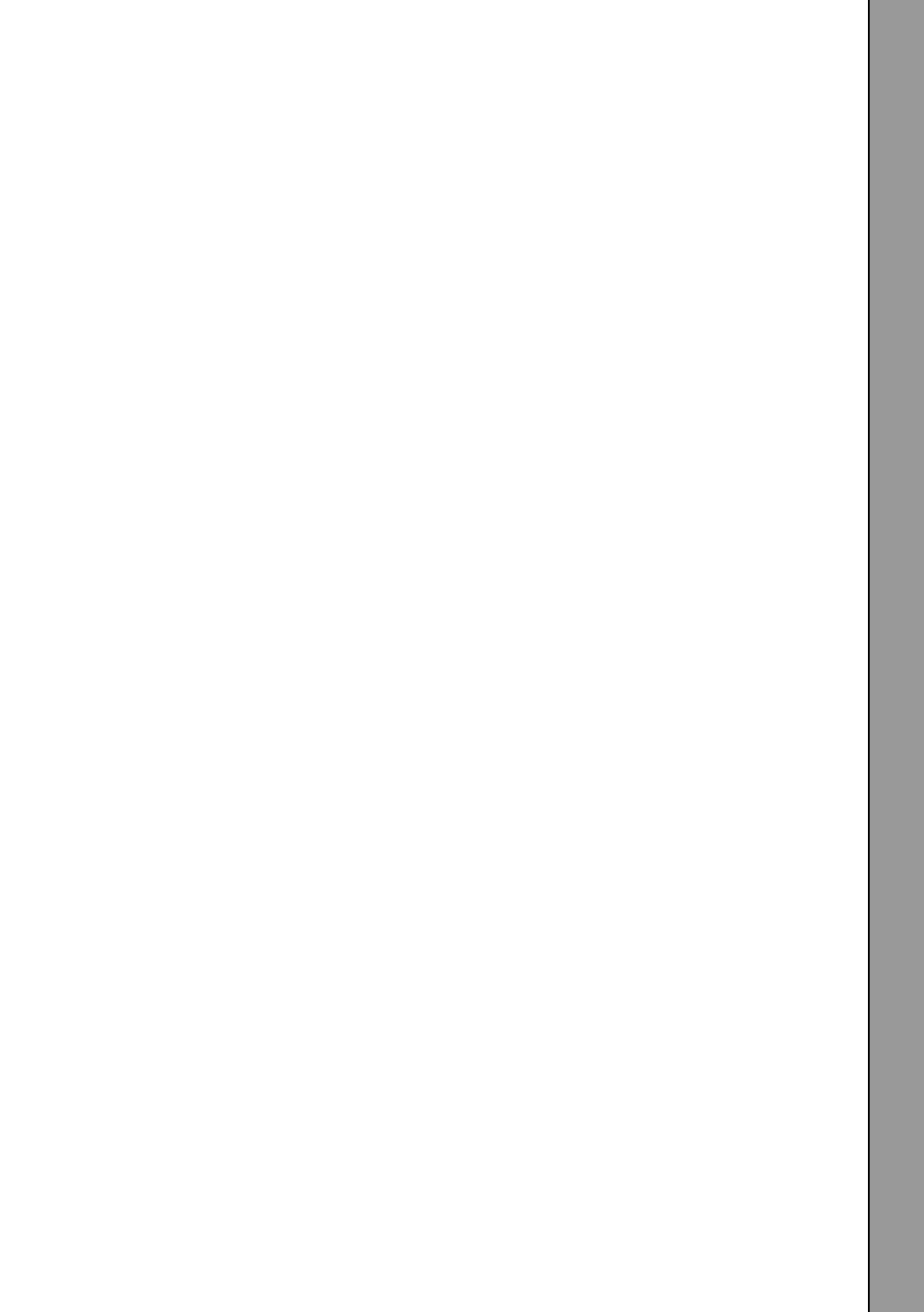

8. RUSSIA'S FINANCIAL CRISIS: CAUSES, CONSEQUENCES AND PROSPECTS

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1. Resume

After a decade of high growth, the Russian economy is experiencing a slowdown in the wake of the global financial crisis. While Russia's strong short-term macroeconomic fundamentals make it better prepared than many emerging economies to deal with the crisis, its underlying structural weaknesses and high dependence on the price of a single commodity make its impact more pronounced than otherwise. Prudent fiscal management and substantial financial reserves have protected Russia from deeper consequences of this external shock. The government's policy response so far – swift, comprehensive, and coordinated – has helped limit the impact. Short-term macroeconomic stabilization and cushioning impact on the poor have to be the immediate priorities as the authorities continue to adjust their short-term policy responses to changing economic circumstances. But the crisis also presents an opportunity to address the medium- to longer term challenges of competitiveness, economic diversification, and financial sector modernization which are necessary to boost growth and living standards. This would ensure that Russia emerges from this global crisis with a stronger basis for dynamic, productivity-led growth and is better placed to take advantage of global integration.

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[1] This note is based on the World Bank's Russian Economic Report No. 17 (www.worldbank.org/russia) prepared by a World Bank team led by **Zeljko Bogetic**, Lead Economist for Russia and PREM Country Sector Coordinator. The team members were: Karlis Smits, Sergey Ulatov, Stepan Titov, Olga Emelyanova, Annette de Kleine, Victor Sulla, and Marco Hernandez.

2. Context and Causes

Output and investment – slowing…

After a decade of high growth, the global financial crisis has affected Russia, posing a new challenge for macroeconomic policy. On the heels of high oil prices, favorable international environment and prudent macroeconomic policies, Russian economy has grown at an impressive 7 percent a year during the decade 1999–2007 – and at an overheating 8 percent in the first half of 2008. Since July 2008, with the collapse of oil prices and capital flows, the Russian economic growth has slowed to only 1.1 percent in the last quarter of 2008. For the 2008 year as a whole, growth was still healthy at 5.6 percent. But 2009 will clearly a difficult year with the intensification of the global financial crisis around the world.

Before the crisis, in the first six months of 2008, real GDP growth in Russia continued at a brisk pace of about 8 percent, reflecting a booming economy, rapid credit growth and strong macroeconomic fundamentals (table 1). This growth exceeds the long-term potential of the economy (estimated in the 6–7 percent range), with clear signs of overheating. An upturn in inflation, a decline in unemployment, a rise in capital utilization, and real wages significantly outpacing productivity growth all indicated an overheating economy against the backdrop of binding supply (infrastructure) constraints.

…against the backdrop of strong macroeconomic fundamentals.

Russia's strong macroeconomic fundamentals, prudent fiscal policy, and lack of exposure to the US sub-prime crisis have partially protected its economy and helped limit the impact of the global financial crisis. Thanks to low sovereign external debt, large twin surpluses (fiscal and external current account), one of the world's largest international reserves, and favorable rating agency assessments, until mid-2008, foreign investors viewed Russia as a "safe heaven," fairly "decoupled" from worsening global financial environment. By building significant fiscal and reserve cushions relative to most other emerging markets, Russia has also managed to delay and limit the impact of the global crisis.

Table 1 Main Macroeconomic Indicators 2004–08

	2004	2005	2006	2007	9M 2008	11M 2008
GDP growth %	7.2	6.4	7.4	8.1	8[a]	7.3[d]
Industrial production growth % y-o-y	8	5.1	6.3	6.3	5.4	3.7
Fixed capital investment growth % y-o-y	13.7	10.9	16.7	21.1	13.1	11.3
Federal government balance, %GDP	4.3	7.5	7.4	5.5	8.1	6.4
Inflation (CPI), % change, e-o-p	11.7	10.9	9	11.9	11.6[b]	13.3[e]
Current account USD bn	58.6	84.2	95.6	76.6	91.2	98.8[e]
Unemployment, %	8.2	7.6	7.2	6.1	5.3	6.6
Reserves (including gold) USD bn, e-o-p	124.5	182.2	303.7	478.8	475[c]	426.5[f]

Notes: [a] data for 2008 Q1-2, [b] data for 10 months, [c] data as of 7 November 2008, [d] data for 2008 Q1-2-3, [e] annual data, [f] data as of 9 January 2009
Source: Rosstat, CBR, Ministry of Finance

But since July 2008, Russia's is "re-coupling" with global trends.

Four major, related shocks appear to have "caused" or transmitted the global crisis to Russia:

- First, the intensification of the global crisis caused ***a sudden stop and then a reversal in capital flows*** as investors fled to quality across world markets, Russia included.

- Second, the global credit crunch and ***tightening external borrowing conditions*** has affected Russia's banking system, which faces its own liquidity problems against short-term external repayment obligations.

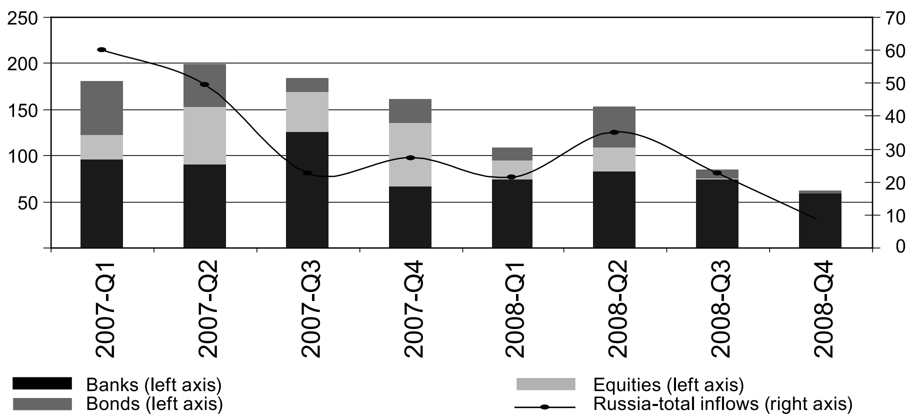
- Third, a ***sharp drop in the price of oil*** began to erode Russia's fiscal and external account surpluses and very large international reserve buffer.

- Fourth, ***Russia's stock market*** experienced a massive decline—largely reflecting the global loss of confidence and the precipitous drop in the price of oil—losing two-thirds of its value in the less than five months to mid-November 2008.

Total gross capital flows to emerging markets plummeted in Q4-2008—down 61 percent over Q4-07. Bond issuance and equity placements collapsed, while cross-border syndicated bank lending remained relatively resilient. In comparison, total flows to Russia showed a steeper 70 percent drop in

Q4-08 relative to Q4-07, with nearly all inflows limited to bank lending. For emerging markets, among the types of inflows, equities posted the steepest decline in 2008, falling 76 percent over 2007, followed by a 51 percent decline in bond issuance. Bank lending posted a less stark 23 percent decline over the same period. In Russia, total gross flows contracted by 45 percent in 2008 over 2007, averaging $7bn per month. With the deepening spread of the financial crisis to the real sector, the Institute for International Finance projects that net inflows to emerging markets will shrink dramatically, from $929bn in 2007 and $466bn in 2008 to only $165bn in 2009 (Figure 1).

Figure 1: Capital flows to emerging markets and Russia shrink with the spread of the crisis (in USD bn)

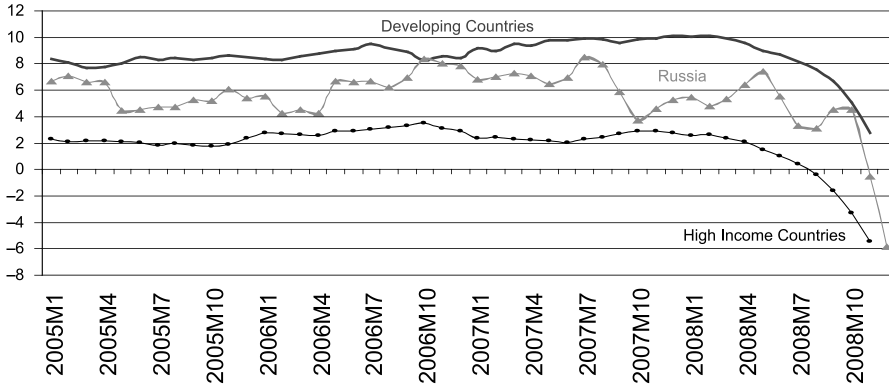


Sources: Dealogic and World Bank

World economic activity collapsed in the final months of 2008, the depth of the downturn surprising many analysts. Measured by industrial production (IP), output contracted 5.4 percent (y/y, 3mma) in high-income countries as of Nov-2008—down from a recent peak of 2.9 percent in Oct-2007 (Figure 2). IP slowed sharply in developing countries, posting a fraction of the recent high of 10 percent growth in Dec-2007 to 2.8 percent in Nov-2008. In Russia, IP growth contracted 0.5 percent (y/y, 3mma) over the same period, with the contraction deepening to 5.9 percent in the final month of the year. This compares with a recent high of 7.4 percent growth in May-2008. A confluence of negative factors have led to plunge in activity, as consumers and businesses alike are being squeezed by tighter credit conditions, severe deterioration in business and consumer confidence, and negative wealth effects from falling asset prices. Negative feed-back growth effects from the point to a deepening of the current downturn and significant downside risks.

Figure 2: Activity in both developing and high income countries collapsed in late 2008

Industrial Production (Annual % change - 3 month moving average, seasonally adjusted)

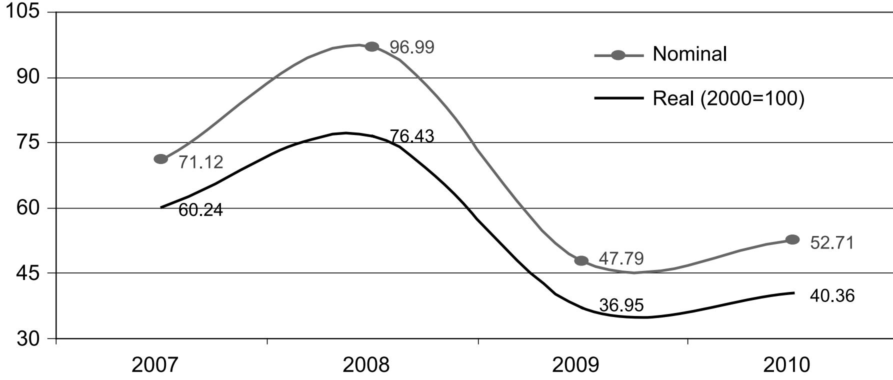


Sources: IMF, Datastream Thomson and World Bank

Crude oil prices collapsed from over $140 per bbl in July 2008 to 43.8/bbl average in January 2009, bringing down the Russian stock market, which heavily over-represents oil and gas sector (over 60%) in its capitalization. U.S oil demand fell nearly 6 percent in 2008, with gasoline consumption off 3.3 percent. Demand has declined in other OECD countries, and has recently started to fall in some developing countries, notably in Asia. Meanwhile, OPEC agreed to cut production by 2.2 mb/d as of January 1, 2009 bringing total cuts since September to 4.2 mb/d., the largest coordinated cut in a very long time. Going forward, weak demand and rising supplies are expected contribute to a decline in the World Bank's average crude price forecast from an annual average of $97/bbl in 2008 to mid-$40/bbls range in 2009 and $52.7/bbl in 2010 (Figures 3–4; preliminary, subject to revision).

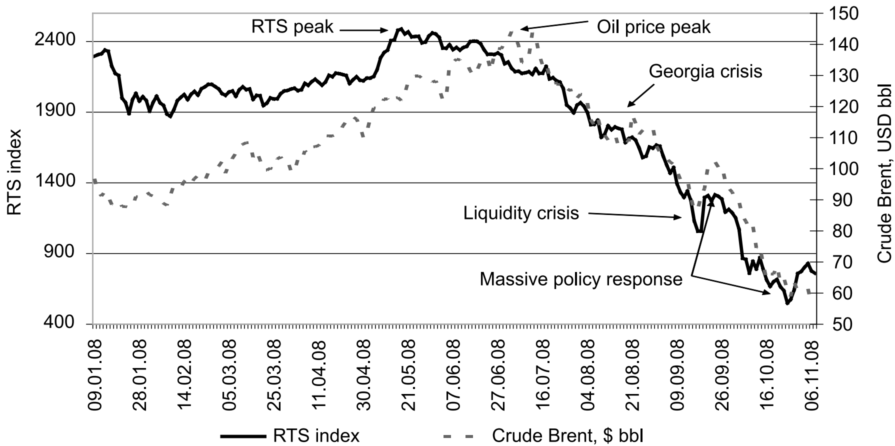
Figure 3: Oil prices plunge on faltering demand and rising stocks, despite production cuts

World Bank Oil Price Forecast – Average Crude (Brent, Dubai and WTI) simple av. USD/bbl



Source: World Bank Staff

Figure 4: Russia's stock market collapse and oil prices

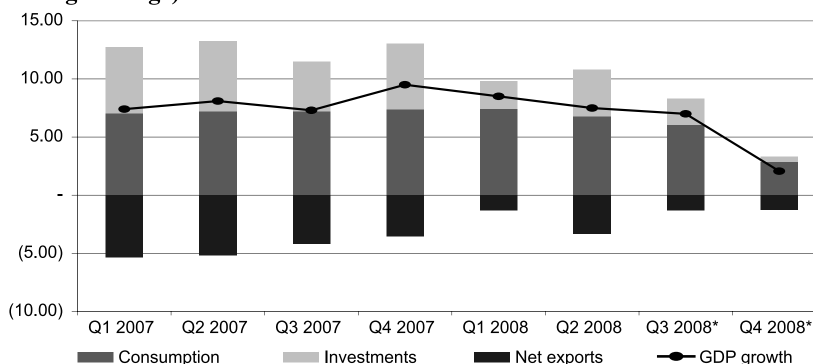


3. Consequences

Domestic demand—a key engine of Russia's growth—has weakened

The deceleration of investment growth in the first half of 2008 has marked the beginning of a gradual slowdown in aggregate demand, with consumption following suit. Following the boom in the first half of 2008, investment—with consumption, the main driver of short-term growth—slowed significantly, due to state corporations and to extraction industries. Supply constraints and a gradual rise in global uncertainties and associated changes in investment sentiments, international and domestic, played a role in these developments. Foreign direct investments have slowed. And tighter credit conditions and rising uncertainty and weak labor market outlook has adversely affected consumption growth (figure 5).

Figure 5: Demand sources of Russia's real GDP growth by quarter, 2007–2008 (percentage change)



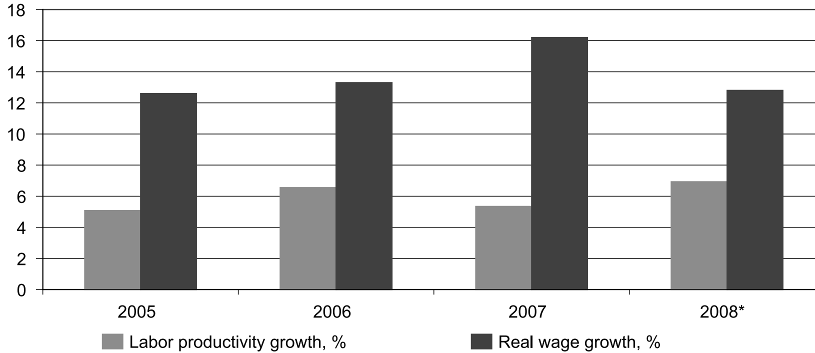
* World Bank staff projected estimate.
Source: World Bank decomposition and estimates based on Rosstat data.

Labor markets moved from full employment to high unemployment

Starting from full employment as late as September 2008, Russia's unemployment has shot up sharply in the last quarter of 2008, but real wage gains still outpaced productivity. Unemployment rate went up from 5.3 percent in September to an estimated 7.7 percent in December 2008. Large, non-tradable and labor-intensive sectors such as construction and trade were particularly hard hit, delaying the execution of existing and new projects and adjusting to higher borrowing costs, more difficult access to credit,

uncertain demand, therefore, lower profit margins. Similarly, the ongoing restructuring in the banking sector has resulted in a rapid increase in the number of “white collar” unemployed. Despite softening of the labor market, real wages continued to outpace productivity in 2008 as a whole, although the latest monthly data suggest that this trend is now being reversed (Figure 6).

Figure 6: Labor productivity and real wage growth, 2005–2008 (in percentages)

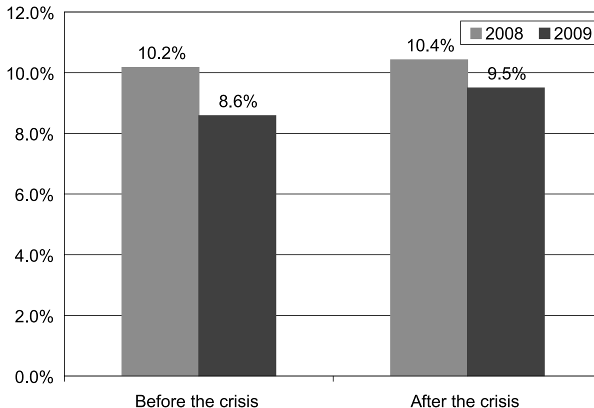


Source: Rosstat and World Bank staff estimates.
* Labor productivity growth Jan-June 2008, the real wage growth Jan-September 2008.
Note: Labor productivity calculated as output (GDP) per employed person.

…and the impact on poverty is intensifying

Over the past eight years, Russia’s robust growth has reduced poverty. Real GDP per capita grew on average by about 7 percent a year between 2000 and 2007. Meanwhile, the poverty headcount rate declined from 29 percent in 2000 to 13.4 percent in 2007. This implies that approximately 30 million people appeared to have moved out of poverty during 2000–07.

Box figure 1: Projected poverty headcount rates for 2008 and 2009



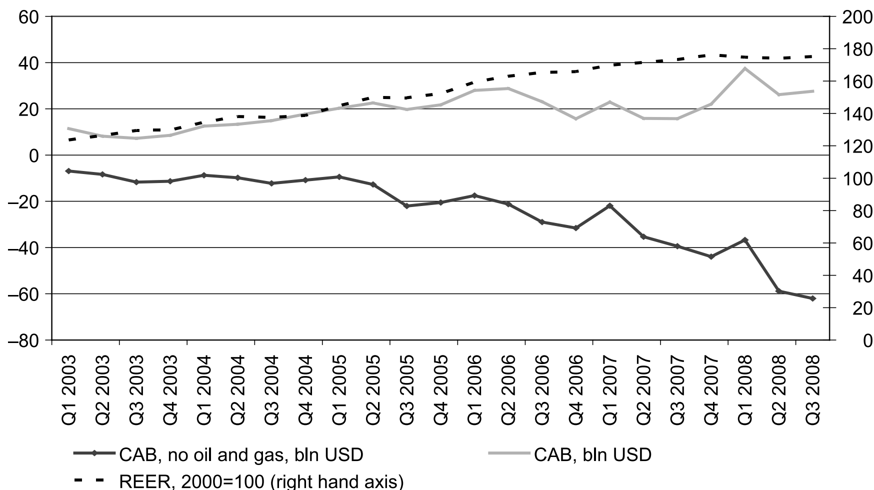
Source: World Bank staff calculations.

The implications of the financial crisis on Russia's poor are troubling. Figures 1 and 2 show the projected impact of the financial crisis on Russia's poor using Rosstat's 2006 household budget survey. Projections of future changes in poverty rates are based on two scenarios: (1) a "before the crisis" scenario, where we assume that real GDP per capita would growth at 6.8 percent in 2008 and 6.5 percent in 2009; and (2) an "after the crisis" scenario, where we predict a slowdown in per capita growth due to the ongoing financial crisis, resulting in a GDP per capita growth rate of 6.5 percent in 2008 and 3.5 percent in 2009. These early estimates, made in November 2008, are already being taken over by the worsening growth outlook so the actual impact is bound to get worse.

…And balance of payment position worsened significantly.

Non-oil external current account continued to widen. As a better measure of the underlying external trade and service account developments than the full current account in oil rich countries, non-oil current account deficit has continued to widen, partly in response to the past appreciation of the ruble (figure 7).

Figure 7: Current account balances and the real effective exchange rate

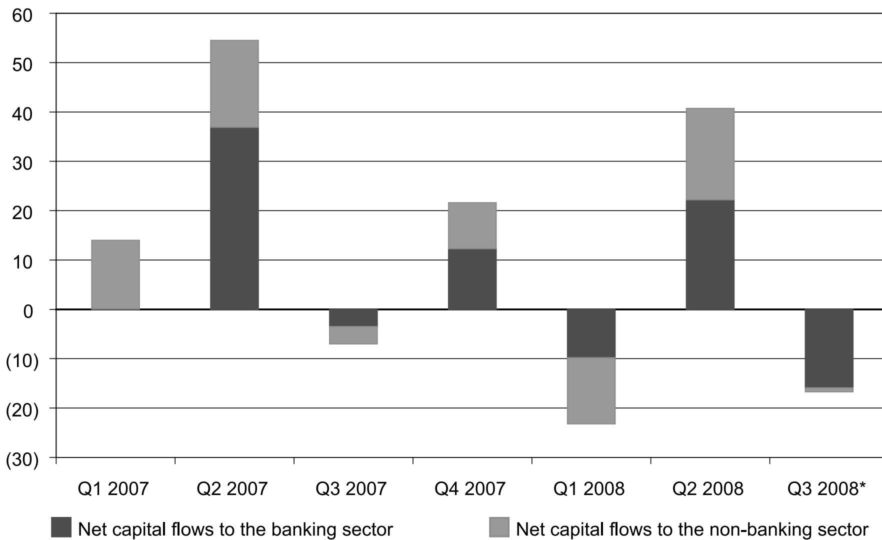


Source: World Bank staff calculations based on Rosstat and CBR data.

After record inflows in 2007, Russia has experienced a classic "sudden stop" and, then, reversal in capital inflows since mid-2008. Moreover, in 2007–2008, capital flows became more volatile, and the banking sector

experienced a sharp reversal of capital inflows (figure 1.8). After reaching a peak USD84.3 billion in 2007, the account turned to a massive deficit of about $130 billion in 2008, reflecting mainly a sudden reversal in capital inflows in the third and quarters of 2008. With tightly managed exchange rate, this resulted in a decline in the stock of official reserves from about $600 billion in the summer 2008 to about $383 billion in early February 2009. Two main factors were behind the deterioration of the capital account. First, changes in investment sentiment triggered a reversal of capital flows, including short-term speculative flows and FDI. Second, changes in foreign exchange expectations resulted in the unwinding of ruble positions held by foreign investors betting on a continuing ruble appreciation.

Figure 8: Quarterly net capital flows in USD billion, 2007–2008



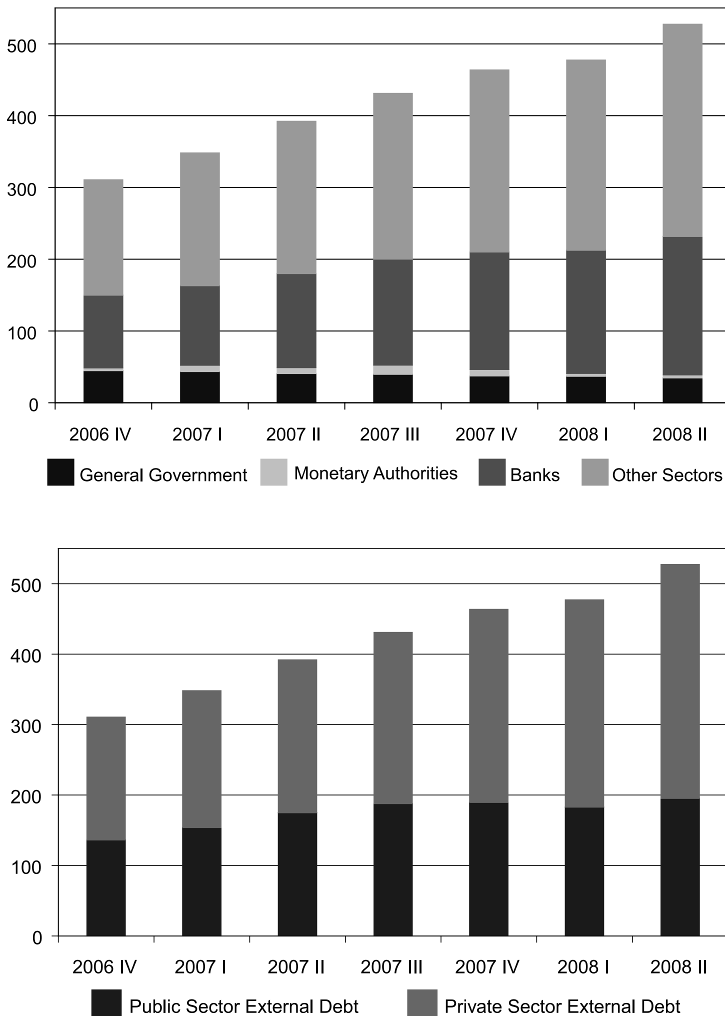
Source: CBR

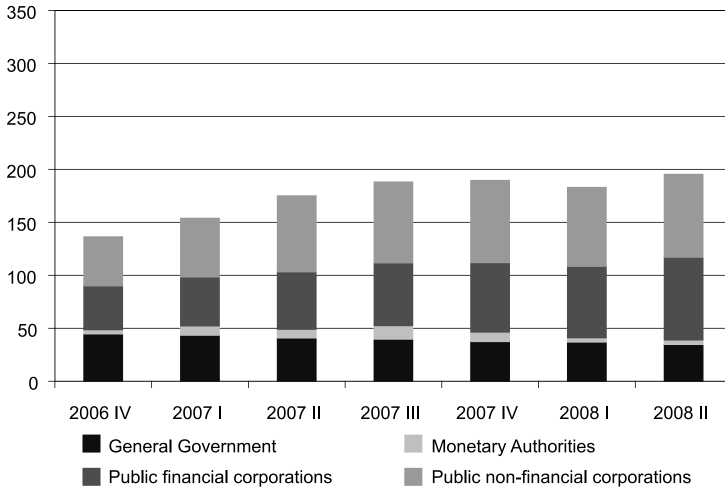
Moreover, external corporate and banking debt grew rapidly…

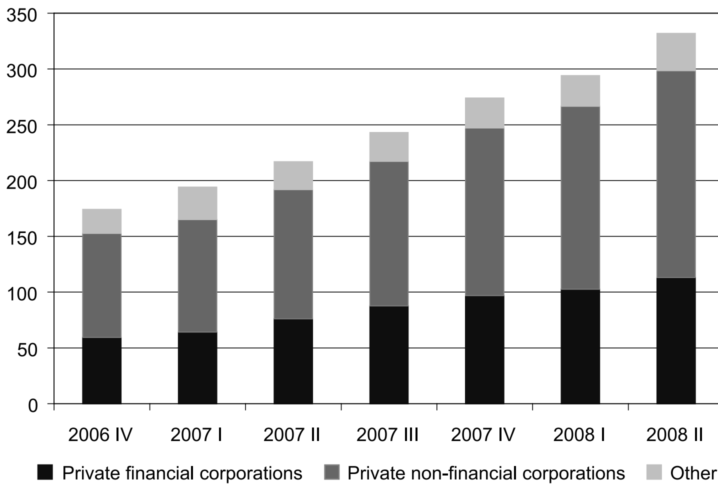
Russia's private corporate and banking debt grew rapidly in the first half of 2008 and total external debt rose by USD50.1 billion in the second quarter of 2008 and rollover risk has risen. Although the general government's external debt remains modest, the private corporate and banking debt increased by USD37.8 billion in the second quarter of 2008. The corporate sector—officially classified as "private" but including such state-controlled enterprises as Gazprom—accounts for most of the debt stock (figure 9). In the corporate

sector, both financial and nonfinancial institutions have increased their debt stock, but nonfinancial institutions have increased it more rapidly. Public external debt has moderated. While the overall share of short-term external debt of Russia remains low, accounting for less than 20 percent of total external debt, the share of short-term debt in private financial institutions is significantly higher at around 40 percent. High levels of short-term debt make these private financial institutions, predominantly small and medium-size banks that were able to tap into international capital markets funding, vulnerable to the rollover risk and sudden changes in investment sentiment.

Figure 9: Russian total external debt stock (USD billions)







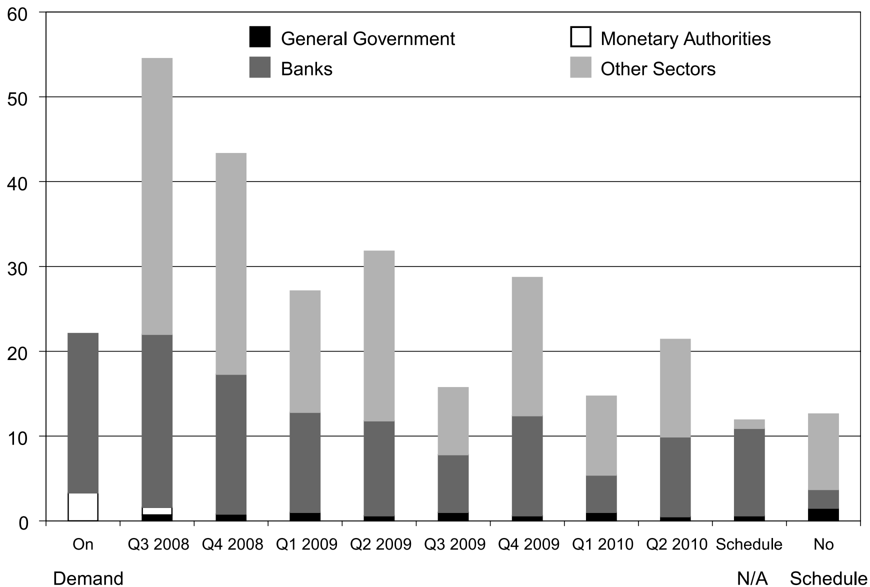
Sources: CBR and World Bank staff calculations.

…but systemic bank risk remains limited

Despite hefty repayment obligations at a time of sharply tighter global credit and higher rollover risk, systemic risk remains limited. Russia's has successfully weathered a difficult period of the last two quarters of 2008 during which some USD100 billion matured. In 2009, these repayments

amount so some $120–140 billion and should be manageable under the baseline economic outlook (Figure 10, see below). Certain sectors, especially private financial corporations, are likely to face challenges in rolling over their external debt. In addition, higher prices for debt refinancing are inevitable. Even so, systemic risk to the banking sector appears limited because of the government's demonstrated resolve to support the systemically important banks and a sizable package of measures taken to date. A recent IMF mission has also concluded that the systemic risk remains limited (see IMF's Press Release www.imf.org No. 08/225 of September 26, 2008).

Figure 10: Repayment schedule of Russia's external debt (in USD billion)



Source: CBR.

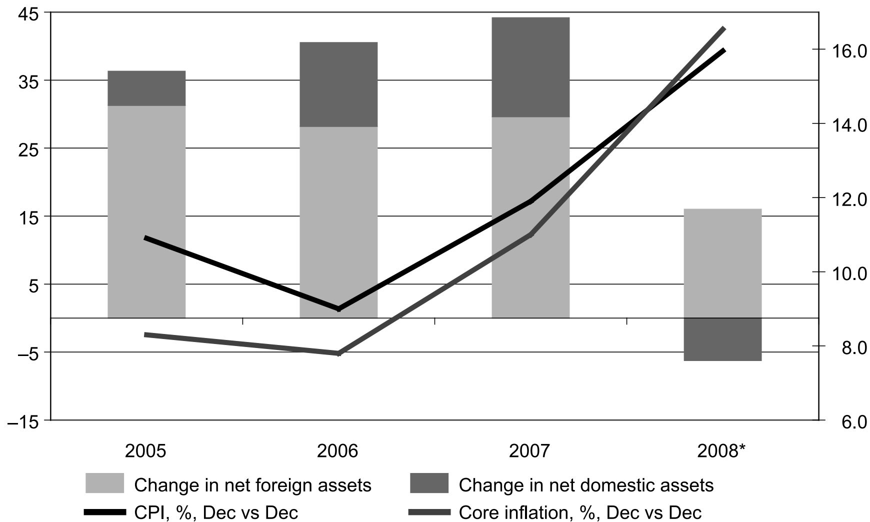
Inflation risk subsided, liquidity risk increased, and monetary policy loosened

For the first eight months of 2008, the monetary policy aimed to gradually tighten liquidity conditions to fight double digit inflation fueled by large capital inflows in the context of tight exchange rate management. Yet, the gradual tightening of money was not sufficient to engineer a decline in inflation, which remained high on the back of high food import prices, inflation expectations and high aggregate demand (Figure 11).

But with liquidity risks rising sharply since September 2008, the central bank moved decisively to support system's liquidity and help restore confidence. Dramatic worsening of global financial conditions in September 2008 and the liquidity crisis caused the central bank to change the policy course and provide substantial liquidity in its efforts to alleviate the confidence crisis and unfreeze the interbank credit market.

These actions were swift, appropriate, and proportionate to the problem at hand. And they helped to temporarily stabilize the financial markets after the tumultuous week of 15–19 September. An estimated 400 billion rubles of additional liquidity (USD15 billion or 1.2 percent of GDP) were pumped into the economy in September and October, when the reserve requirements were dropped sharply to 0.5 percent. This temporarily alleviated the sharp liquidity and confidence crisis in mid-September, but liquidity pressures continued later in October and prompted the government to take additional measures to ensure the rollover of external obligations by banks and corporations. In hindsight, this was the right decision, helping avoid more difficult liquidity conditions in September and early October than otherwise.

Figure 11 Monetary growth and inflation (in percent; monetary growth-left scale; inflation-right scale)



Note: 2008 data are as of September
Source: CBR; Rosstat; World Bank calculations

4. Policy Response

Fiscal policy aims to limit the impact of the crisis

Russia's consolidated (general) budget was executed with the strong surplus of about 4 percent of GDP in 2008 and 2009 budget is now revised, likely to result in significant fiscal deficit. Given the balance of risks that has shifted dramatically toward growth, the financial sector, and the real economy, and the fact that Russia has substantial resources accumulated in the two oil funds (about $210 billion), Russia has fiscal space to allow the fiscal deficit to grow during 2009 in order to cushion the impact of the crisis. Long-term, public expenditures will clearly need to adjust, however, to keep the overall fiscal balance on a long-term sustainable path in case of prolonged periods of very low international prices of oil and weak global demand but in the short-term and given large fiscal resources, the authorities are appropriately targeting a significant fiscal deficit, which is emerging in large part because of the collapse of the oil tax base and additional, crisis-related spending.

Although the direct fiscal costs of the announced anti-crisis measures so far are manageable, quasi-fiscal costs are much larger. Estimated direct fiscal costs implemented through November 2008 are only 190 billion rubles (USD7.6 billion or about 0.58 percent of Russia's GDP in 2007) but the quasi-fiscal and contingent costs could reach up to about 4,639 billion rubles (USD185 billion, or about 14.7 percent of Russia's GDP in 2007) (Table 2). These additional commitments have reduced the fiscal space and halted many important initiatives, especially large capital expenditures to address infrastructure bottlenecks that might be scaled down or postponed. Nevertheless, Russia has some $210 billion in oil funds reserves that could be used to finance a sizeable fiscal deficit emerging in 2009. It is likely to use this financing option to continue cushioning impact of the crisis on the economy and the poor.

Table 2: Aggregate fiscal, quasi-fiscal and monetary cost and sources of financing of anti-crisis policy measures (in billions of rubles, unless otherwise indicated)

	Fiscal	Quasi-fiscal	Monetary	Total
Federal Budget	190	up to 2,839		up to 3,029
..o/w National Welfare Fund		*up to 700*		*up to 700*
Central Bank of Russia		up to 1,800	830	up to 2,630
Total (in bn rubles)	***190***	***up to 4,639***	***830***	***up to 5,659***
Total (in USD bn)	**7.6**	**up to 185.0**	**33.0**	**up to 225.6**

Source: World Bank staff estimates.

5. Policy challenges going forward

Russia's first challenge is to limit the overall impact of the crisis on liquidity and the real economy while not losing control of the public finances and not letting inflation get out of control. This will be a delicate balancing act. But Russia is better prepared today to deal with these new challenges than at any time since the beginning of the transition. Despite some similarities with the crisis triggers of 1998, Russia today is a much larger economy with much stronger macroeconomic fundamentals. Its policy response–loosening monetary policy, supporting banking sector and repayment of short-term corporate and financial obligations, and implementing a number of quasi-fiscal measures–so far has been swift, massive, and broadly appropriate.

The second challenge is to intensify the efforts to diversify the economy, strengthen institutions as well as the financial sector for sustained, long-term growth. Oil and gas exports continue to account for more than two-thirds of Russia's export revenue and more than 15 percent of GDP. But the crisis shows how dependent the Russian economy is on oil prices and how much it needs to diversify and strengthen its financial sector for sustained, long-term growth. Despite strong macroeconomic fundamentals, structural weaknesses in the banking sector and a limited economic base make Russia vulnerable to highly correlated, multiple shocks of a decline in oil price, a sudden reversal in capital flows, and a drop in the market sentiment and the stock market. Russia's economic recovery will depend largely on its ability to regain the confidence of domestic consumers and domestic and foreign investors. The crisis can be a catalyst for continuing the structural reforms to improve productivity and the business climate and fiscal reforms to strengthen the economy's non-oil tax base. The way forward is diversification through greater openness, greater macroeconomic stability, more use of cutting-edge technology and knowhow, more foreign direct investments, and a stronger and healthier banking system.

The third challenge is to continue the integration into the global economy, including the acceleration of accession to the WTO. Russia has benefited substantially from being more integrated with global markets. Indeed, integration of trade, capital, and finance has helped Russia reap important benefits during the past decade of rapid economic growth. A key source of investment and growth in the past years has been long-term equity and debt from foreign investors. The WTO accession can be used as a means towards

locking in domestic reforms, ensuring that Russia benefits from a rules-based international trading regime, as well as to strengthen Russia's future integration into the world economy by improving its policies and institutional capacity. Russia's active participation in the design of the new international financial architecture will solidify its role in global financial markets.

The fourth challenge is to limit the impact of the crisis at the regional level and be vigilant to the emergence of non-payment problems. First, the credit crunch is likely to have a negative effect on regions that have relied on debt financing and narrow tax bases. Although aggregate sub-national debt levels including guarantees are very small for the economy as a whole (currently 527 billion rubles, or approximately 1.5 percent of GDP), the slowdown of economic growth and shortfall in tax revenues will put additional fiscal pressures. Furthermore, for regions that have relied on debt to cover its expenditure gap, the cost of borrowing is likely to increase. Second, in an environment with more limited access to borrowing different sectors of economy once again risk an increase in non-payments. In addressing this potential problem, the authorities need to carefully weigh the implications of its policy mix. Although softening of budget constraint on the state owned companies (especially utilities) or introduction of administrative price controls might seem as an easy solution to minimize the negative social consequences of the economic slowdown, such policy will distort incentives for enterprises to restructure and use inputs and existing assets more efficiently.

Finally, a prolonged economic recession in 2009 might require an introduction of a well targeted and structured, fiscal stimulus package to enhance key drivers of sustained economic growth. This is the subject of the ongoing policy deliberations around the revised 2009 budget. From the macroeconomic perspective, Russia is probably a good candidate for such a fiscal stimulus as economic activity drops significantly below potential, inflation risks subside, and fiscal reserves remain comfortable. The objective would be to primarily cushion the impact on the poor and unemployed, boost aggregate demand and create more favorable environment for a more rapid recovery of private investment. To have desired effect, however, such a fiscal stimulus (which could consist of a combination of spending increases and targeted tax cuts) must be temporary, transparent, affordable, rule-based, and implemented as exceptional policy in an exceptional situation. This is important for governance reasons and for credibility of the authorities policy response discussed below. But it is also important to minimize the potential longer-term "moral hazard" and incentives problems that arise from state support for enterprises and banks that made inadequate commercial and

borrowing decisions. In terms of structure, focus of such additional spending might need to be on cushioning the impact on the poor and unemployed, supporting small and medium size enterprises, and addressing the worst infrastructure bottlenecks.

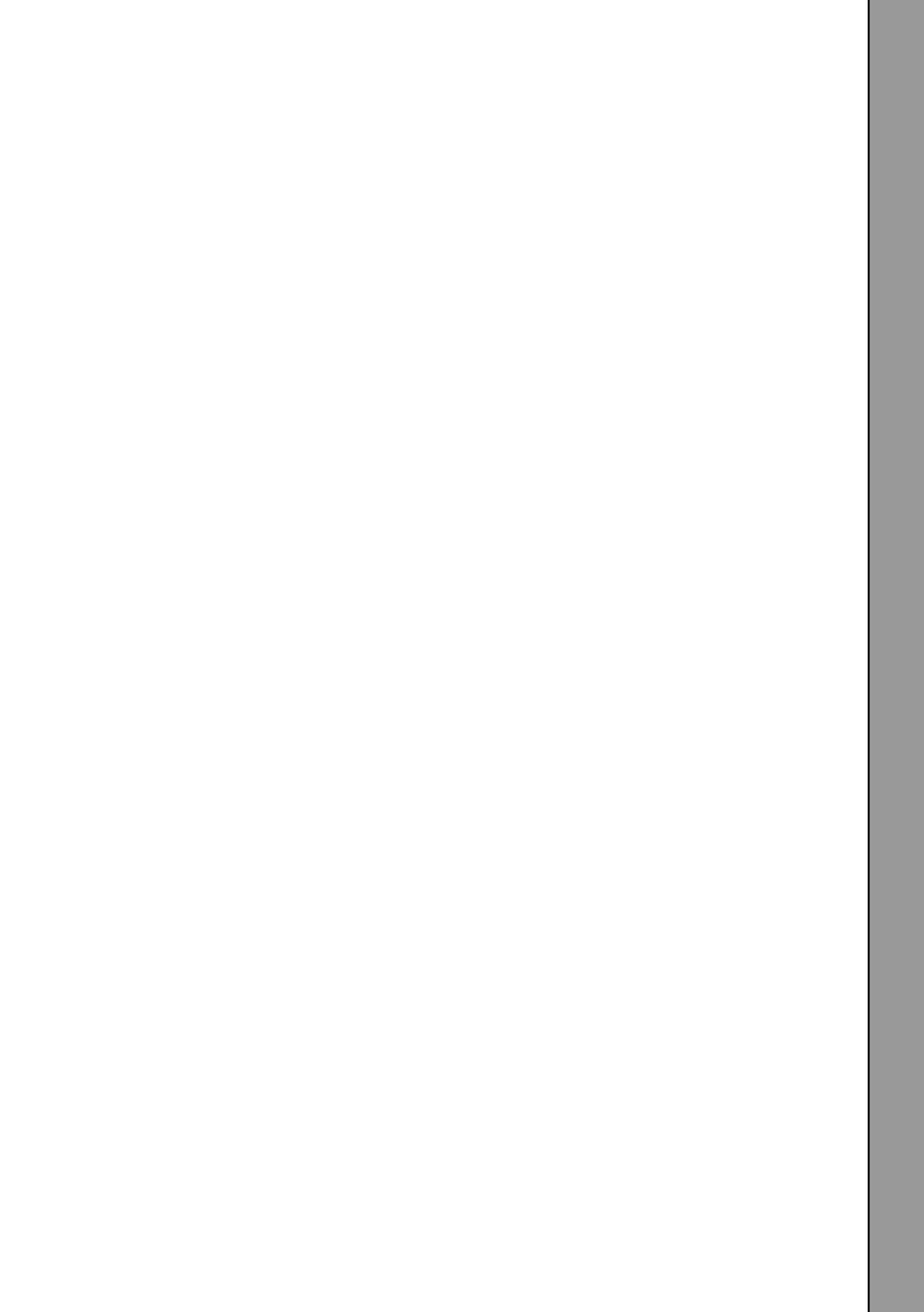
Finally, it is important to realize that faced with the global crisis governments can and should act but they cannot do everything and, therefore, they must be strategic in their policy response. The scale of the global crisis is such that no country is spared and there is a limit to how much any government can do; those limits are dictated, inter alia, by the fiscal and debt situation and implications of governments' actions for currency stability and inflation. What this means is that governments must allocate scarce resources to the most important uses and pressure points caused by the crisis. In the case of Russia, in 2009, as discussed above, the country is better prepared and has more resources to address some of the consequences of the crisis. But even Russia will have to be selective, focusing its considerable resources on the areas where crisis is likely to have the biggest impact: the poor, unemployed and the vulnerable, small and medium size enterprises, and infrastructure.

6. Outlook for 2009

Global and Russia-specific outlooks are uncertain and subject to revisions. Given that the global financial outlook remains uncertain as the crisis continues to unfold in the Western countries that are implementing major policy packages, the outlook is especially uncertain both in terms of global demand and oil prices. Key global assumption is current, *preliminary* World Bank projections of oil prices in 2009 of about USD 47/bbl. On that basis, real GDP growth for 2009 as a whole is likely to turn negative (about –1.4 to –2.5 percent) for the first time since the 1998 crisis and compared with 5.6 percent growth in the previous 2008.

In sum, the global crisis has affected Russia but the Government has so far responded in a pro-active and comprehensive manner. A lot more may need to be done to implement these measures. Transparency and effectiveness of such policy response is key to ensure that they limit the impact on the real economy. Particular attention will need to be paid to the rising social

impact in terms of unemployment and poverty and the need to alleviate these effects of the crisis. Beyond the short term, attention will also need to be paid to longer-term issues of competitiveness, diversification, and growth of small- and medium- sized enterprises. Such reforms and modernization of the banking sector will lead to improvements in productivity and will help Russia emerge from the current crisis with a healthier and more dynamic economy.



9. THE RUSSIAN ECONOMY IN THE GLOBAL TURMOIL

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1. Introduction

Russia has enjoyed a period of rapid economic growth during the past decade. The GDP had been growing by some 7% per on average and the country achieved a certain level of (unequally distributed) prosperity: At purchasing power parity (PPP), Russian GDP amounted to EUR 1900 bn in 2008 – about 20% more than the aggregate GDP of the new EU member states from Central and Eastern Europe (NMS) – see Figure 1. In per capita terms, Russian GDP exceeded EUR 13,000 in 2008 – about 50% of the EU average – and the speed of catching up to the average per capita GDP level in the EU has been impressive: about 15 percentage points since the year 2000 (this was more than the NMS achieved during the same period).[1] The period of rapid economic growth and rising prosperity associated with surging energy prices coincided with Putin's presidency. Without doubt, this lucky coincidence contributed to lift Mr Putin's extraordinary popularity: his approval ratings fluctuated around 70% during his whole presidency.

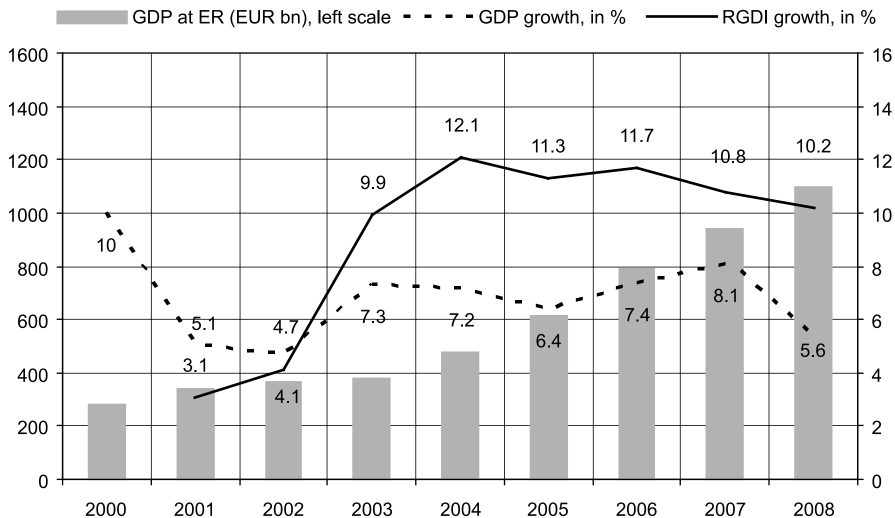
[1] See Podkaminer, L. and Pöschl. J. (2008), Annex Table I.

Russian economic growth during the past decade has been largely based on rising energy prices. The resurgence of Russia as a regional power in the Commonwealth of Independent States (CIS), deteriorating relations with the European Union (EU) as well as the challenges of integration in the European economy have also been closely associated with Russian economic revival and developments in the energy sector. The current global crisis hits Russia disproportionally hard: both the stock market, energy and metal prices, recently also industrial output have collapsed. Short term prospects are highly uncertain, though a return to robust growth is likely in the medium run.

2. Russian economy and the ambivalent role of energy

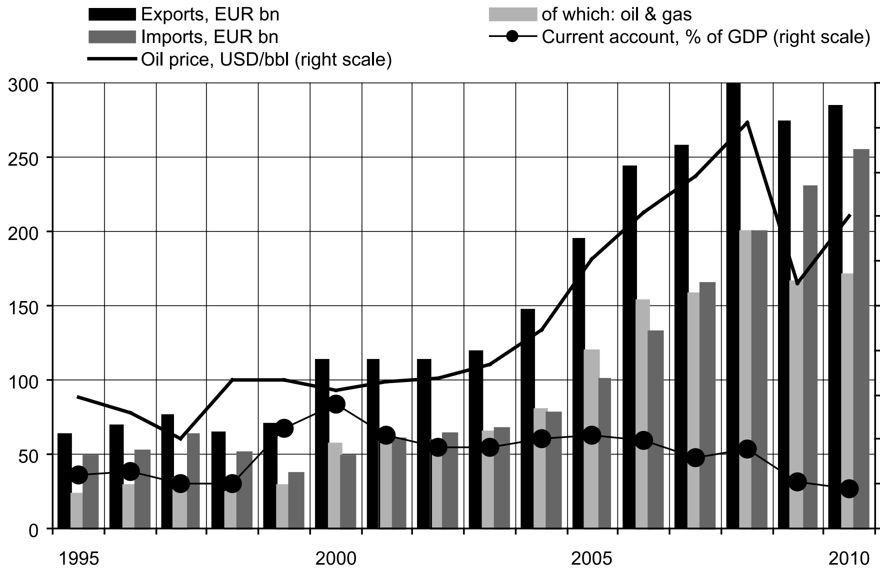
Indeed, most analysts – including the present author – were in the past busy repeatedly revising GDP growth forecasts for Russia upwards, largely owing to surging energy prices. Thanks to huge windfall gains from high world market energy prices and related terms of trade improvements, Russia was able not only to repay nearly all her public external debts, but to accumulate almost USD 600 billion of foreign exchange reserves by mid-2008. Apart from the Stabilization Fund (recently renamed Reserve Fund), another part of windfall earnings from oil and gas exports was accumulated in the newly established National Welfare Fund. Moreover, several national development projects (targeting infrastructure, housing, the health sector, education, and agriculture) were launched and the salaries in the public sector and pensions were raised.

Figure 1: Russian economic growth: GDP and RGDI*



*) RGDI is Real Gross Domestic Income (GDP adjusted for terms of trade effect) – see Havlik (2008) for details.

Figure 2: Russian external sector and oil prices



Source: Goskomstat, CBR, own calculations.

Figure 2 shows how the development of Russian exports has been closely linked to oil prices. Indeed, the surging revenues from energy exports have accounted for a major (and growing) share of total export revenues. Yet after the surge of export revenues during 2004-2006, the export volume grew only slowly while imports (in both real and nominal terms) soared by about 25% in 2007. As a result, the trade and current account surpluses diminished and the contribution of real net exports to GDP growth has been negative (see Figure 3). The share of energy in total export revenues dropped by about 2 percentage points in 2007 compared to 2006 (to 61%). The sharp jump of oil prices in the first half of 2008 resulted in an increase of the share of energy in total export revenues to about 67% in that year as a whole.

3. Return of double-digit inflation

Until very recently, Russia was awash in money: both foreign exchange reserves and capital inflows were at record levels, the government budget has been in a large surplus. The shadow side of that economic boom was – apart from growing assertiveness, nationalism and a revival of some ugly remnants of past Soviet stereotypes – the return of double-digit inflation and a sizeable rouble appreciation in real terms. The appreciation pressure resulted from the huge inflows of foreign exchange, despite some relief provided by the Reserve and National Welfare Funds. The managed peg exchange rate regime and the full liberalization of capital account transactions (since June 2006) required massive currency interventions in order to avoid an even more pronounced appreciation. Besides, consumer price inflation was fuelled by rising prices for food, energy and housing as well as by administered tariff adjustments. These factors translated into double-digit annual inflation in both 2007 and 2008 (Figure 3) and to a sizeable real appreciation of the Rouble. Since the beginning of 2000, the Rouble appreciated by almost 50% against EUR (Figure 4; appreciation against USD was even more pronounced). At the end of 2008, the appreciation trend has been reversed as the Central Bank was repeatedly forced to devalue in the fight against rising capital outflows (see below).

4. Diversification with Industrial Policy tools

The three-year budget plan for the period 2008-2010, adopted in May 2007 and currently under revision, reflected important changes in economic policies. First, future budget revenues should depend less on energy proceeds. Second, government expenditures should increase (even as a share of GDP) with state-sponsored priority programmes to benefit most. The long-discussed controversial idea of Industrial Policy (IP) has apparently gained official blessing. The government-sponsored IP offers targeted support to various public-private partnership projects in the automotive, aviation, shipbuilding and selected high-tech industries (such as nano, nuclear and space technologies). The efficiency and practical implementation of IP measures raises serious doubts – not least due to widespread corruption and other institutional bottlenecks.

Figure 3: Russian consumer price inflation and money supply (M2)

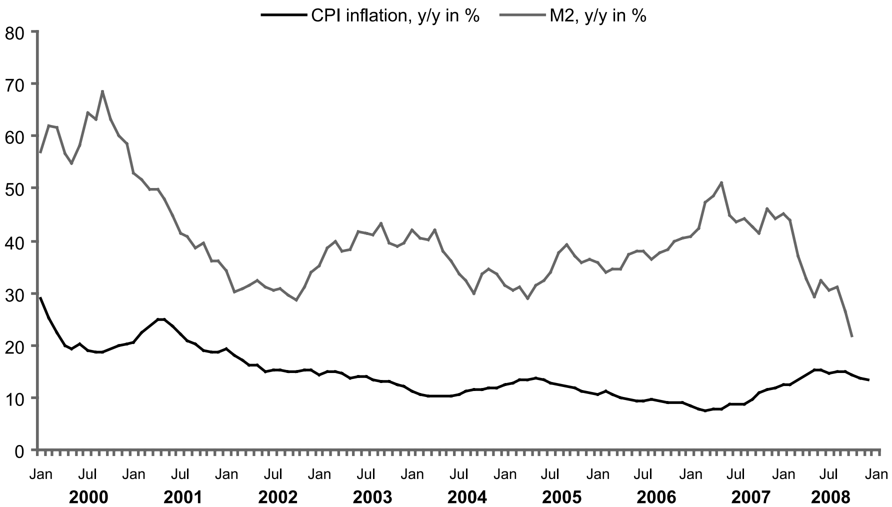
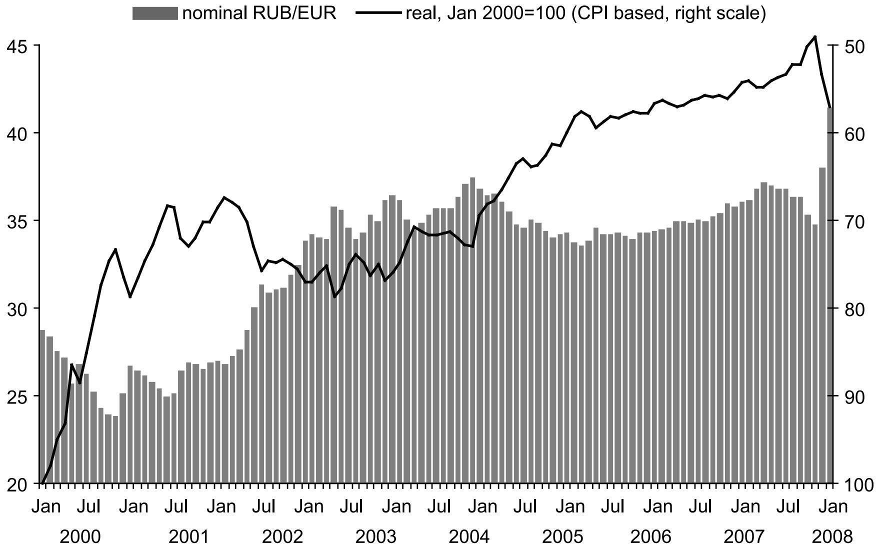


Figure 4: Nominal and real exchange rates (Rouble per EUR)



Source: wiiw Monthly Database, Goskomstat, CBR, own calculations.

Notwithstanding current global turmoil, the main challenge for the Russian economy in the medium and long run is whether it will succeed in replacing energy exports as the key growth driver by the development of other sectors (diversification towards manufacturing, high-tech branches, services, etc.), and how it will cope with the acute demographic crisis (the population is projected to decline by nearly 10 million in the coming decade). The latest (August 2008) officially endorsed long-term development programme until 2020, prepared by the Ministry of Economic Development and Trade, envisaged in its 'innovation scenario' an ambitious economic diversification away from the current heavy reliance on energy and a gradual switch to innovation-based development supported by the above-mentioned IP instruments, as well as the completion of reforms aiming at an improved climate for investments and entrepreneurship. Growing investments in transport infrastructure, education, health and R&D should help to generate and maintain an average annual GDP growth rate above 6% over the next decade. In this scenario, the Russian economy would restructure, become more efficient, modern and competitive in the medium and long run. Alternative scenarios, based on continued heavy reliance on energy resources, lower oil prices and less investments would result in lower GDP growth rates – see Dashkeyev (2008), Vedomosti, No. 146, 7 August 2008.

The chances for a success of the "innovation development" scenario have diminished in the aftermath of the August 2008 conflict with Georgia and the collapse of energy prices. One of the concerns is that the deterioration of Russian relations with the West will lead to serious repercussions for the future path of Russian economic reforms. First victim is the accession to WTO (previously thought possible already in 2008). The delayed WTO accession represents an important setback for Russian economic reforms.[2] Russia has never been too enthusiastic to join the WTO. In fact, the envisaged IP tools could well be in conflict with the WTO rules. In this respect, the delayed Russian WTO accession initiated by the West would play to the hands of more protectionist Russian policy makers and sectoral lobbies. As far as Russian ambitions regarding the above mentioned "innovation development" scenario is concerned, its prospects outside the WTO are also definitely bleaker. Another repercussion of the Russian-Georgian conflict represents the postponement of negotiations of a new EU-Russia Partnership Agreement (to replace the existing Partnership and Cooperation Agreement, which expired at the end of 2007 and has been automatically prolonged for one year). Both types of Western sanctions (delaying WTO and OECD accession, suspending talks about the new Partnership Agreement) would not only further weaken the position of liberal reformers in Russia, but also diminish the success chances for an "innovation-based" development strategy. The early 2009 "gas conflict" with Ukraine has not been instrumental to an improvement of EU-Russian relations either.

[2] WTO accession represents one of the few available institutional anchors for economic reforms in the transition economies which lack the EU accession perspective – see Grinberg, R., Havlik, P. and Havrylyshyn, O., (2008).

5. Effects of the global turmoil

Despite strong economic fundamentals, Russia has been seriously hit by the global crisis - especially after September 2008. The stock market has been hit exceptionally hard: the overall RTS index dropped from the peak of 2488 points reached in May 2008 to below 600 points by mid-January 2009. The stock market dropped by more than 70% - one of the biggest declines among emerging markets. The market capitalisation declined by about USD 1000 bn in the same period. Only in September 2008, the net private capital outflows reached USD 25 bn, followed by another USD 35 bn in October. For the whole year 2008 the capital outflow reached nearly USD 140 bn (net capital inflows exceeded USD 80 bn during 2007). The stocks of a number of Russian blue chip companies (such as Gazprom, Rosneft, Lukoil, Sberbank, Norilsk Nickel, etc.) were hit particularly hard – reflecting largely investors' overreaction, although some fundamental factors might have played a role given the recent decline in the world prices for oil and metals and a high exposure to the short term foreign debts. The adverse external shocks that triggered these events may have been magnified by the domestic political factors (Mechel and TNK-BP affairs from early summer 2008, the war in Georgia in August, the gas conflict with Ukraine at the beginning of 2009, etc.). However, the shallow depth and a relative immaturity of the domestic financial market should keep repercussions on the real economy in check. The current developments probably reflect more of a temporary overreaction of the market participants rather than a lasting worsening of the domestic investment climate. Medium-and long term prospects for economic growth are not bad.

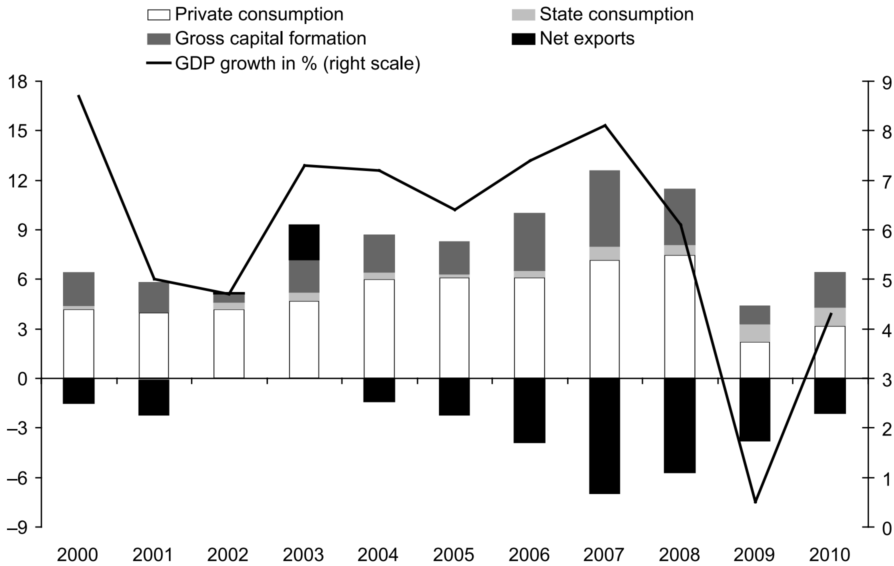
Indeed, potentially more serious than the dismal and volatile performance of the stock market – especially as far as the repercussions on the real economy are concerned - is the tightening of credit conditions. There is no doubt that several large Russian companies (such as Mr Deripaska's Basic Element) and especially smaller Russian banks have been facing difficulties to service and refinance their outstanding foreign debts. The lack and/or dearth of domestic, especially long term credit financing – a by-product of past restrictive monetary policies and high domestic interest rates – motivated Russian companies, even the state-owned or state-controlled ones such as Gazprom, to seek external financing. The private foreign debt reached more than USD 350 bn as of end-September 2008 (an increase by USD 80 since the beginning of the year.

Similar to the US and the EU, the Russian government has adopted various rescue and stimulation packages in order to improve the liquidity of the banking sector and to restore the confidence. The Central Bank released more than USD 100 bn out of its reserves (amounting to USD 430 bn as of end-2008) in order to provide additional liquidity and to suppert the Rouble exchange rate. New credits to the banking sector with a maturity of up to 6 months will be provided via the state-owned Vneshekonombank (VEB) without requiring collateral. In addition, the VEB will provide credits for refinancing short term foreign credits acquiring shares of these companies as collateral (e.g. Mr. Deripaska's Basic Element). Private deposit bank guarantee was raised to Rbl 700 th (EUR 20 th). Altogehter, more than USD 200 bn of state assistance in various forms were earmarked for easing the liquidity of the financial sector. Critics point to the usual dangers of misappropriation and corruption, they also expect that mainly big (or well connected) banks will disproportionately gain from this facility and wonder whether the money will reach the companies facing the liquidity squeeze. It can be expected that a number of small and mid-sized banks will eventually collapse, the banking sector will be streamlined and the state will increase its influence on companies which will seek the financial help.

Russian economic growth reached about 6% in 2008, fixed investments grew by 13% and the real money incomes by 8%. Export revenues grew by 52% (imports by 42%, in USD terms) during January-September 2008 and both trade and current account surpluses increased as well (the latter exceeded USD 90 bn in the first three quarters of 2008). However, the GDP growth virtually collapsed in the fourth quarter 2008 while the inflation remains high and may even accelerate as a consequence of the recent government rescue measures and the depreciation of the Rouble. More than the global financial crisis, especially the oil price represents a crucial variable for Russia in the short, medium and long run. After the recent price spike (with USD 100/bbl oil prices were nearly 70% higher on average in the first three quarters of 2008 compared to previous' year period), a drop has already occurred place – to USD 40/bbl in early 2009. With lower export revenues, GDP growth will slow down in 2009 substantially, the trade and especially current account surpluses will diminish. Some ambitious future spending and investment plans will have to be scaled down and the government revenue will fall markedly following lower export duties on oil. Taken together, a substantial slowdown of GDP growth – to about 1% in 2009 – (forecast by wiiw, albeit at a much lesser scale, already long before the current financial turmoil) will now definitely materialize.

Until recently, the range of GDP growth forecasts for the year 2009 fluctuated around 4%–6% – largely depending on assumptions regarding the level of energy prices. As shown in Figure 5, since 2004 the Russian GDP growth was driven mainly by booming private consumption and, increasingly, also by expanding investments. The contributions of real net exports to GDP growth became negative as the volume of exports has been growing only at a modest pace (less than 10% per year) whereas import volumes have been surging by more than 20% per year. On the supply side, the major part of the overall GDP growth resulted from booming trade, financial services, telecoms and construction activities whereas manufacturing industry and agriculture expanded less than the overall gross value added.

Figure 5: Russian GDP growth and contributions of main components



Source: Goskomstat, own calculations.

Current wiiw forecasts of GDP growth are in a range of 1%–3% for 2009, with some acceleration possible already in 2010.[3] Both investment and consumption are expected to expand by 3%–7% in 2009. Owing to a still limited role of credits in the financing of both consumption and investments (the latter are still financed largely either from own resources or by the government) any effect of the financial crisis should be relatively modest and short lived. The

[3] In its January 2009 Interim Forecast, the European Commission expects for Russia a growth by just 1% in 2009 – see http://ec.europa.eu/economy_finance/pdf/2009/interimforecastjanuary/interim_forecast_jan_2009_en.pdf

domestic financial market may stabilise and even recover fairly soon, yet the investment conditions (including financing and the climate for investments in general) will remain difficult. The nominal growth of exports and especially of imports will slow down, the volume of exports will decline in 2009. The major challenges for the Russian economy – institutional developments, the economic diversification and modernisation – remain also the same as before.

The expected growth slowdown appears inevitable, at least until the end of the decade before any (uncertain) modernization efforts start to bear fruit. Our forecast is based on a modest recovery of oil prices (Urals costing not more than USD 50-70 per barrel in 2010) and limited effects of any (potential) impact of current financial markets turmoil. Both private consumption and investments are expected to grow faster than GDP, real exports will continue to be sluggish since volumes of exported oil and gas will hardly increase while imports will expand rapidly - roughly in line with private consumption and investments. This implies an ongoing negative (albeit diminishing) contribution of real net exports to GDP and – in nominal terms – a gradual reduction of trade and current account surpluses. In fact, the current account surplus which jumped to EUR 70 bn in 2008 (about 6% of GDP) will soon disappear. Inflation will remain above 10% in 2009 and stubbornly close to 10% afterwards.

The recent deterioration of Russian relations with the West in the aftermath of war in Georgia and the "gas conflict" with Ukraine may lead to serious repercussions for the future path of Russian economic reforms. First, the expected accession to WTO (previously thought possible already in 2008) is delayed. The postponement of negotiations of a new EU-Russia Partnership Agreement will probably harm both the EU and Russia: it would further weaken the position of liberal reformers in Russia and strengthen the domestic protectionist and interventionist lobbies. Nevertheless, the Russian medium-term economic outlook remains broadly positive with both consumption and investment (including FDI) expected to expand further. The risks of overheating, especially in housing and credit markets, appear manageable whereas the above mentioned concerns regarding the erosion competitiveness may represent a more serious potential threat in the medium and long run. With a stronger economy, more financial resources and power consolidation at home, Russia's self-confidence (as well as her outward investments) will grow further – and this may lead to more conflicts with both the EU and USA, although the present tensions may calm down provided a further escalation (e.g. over Ukraine) is avoided. However, there is little doubt that both Mr Medvedev and Mr Putin will defend Russian interests – whether these are real or perceived – and these need not be necessarily identical with those of either the EU or the USA and may lead to additional tensions.

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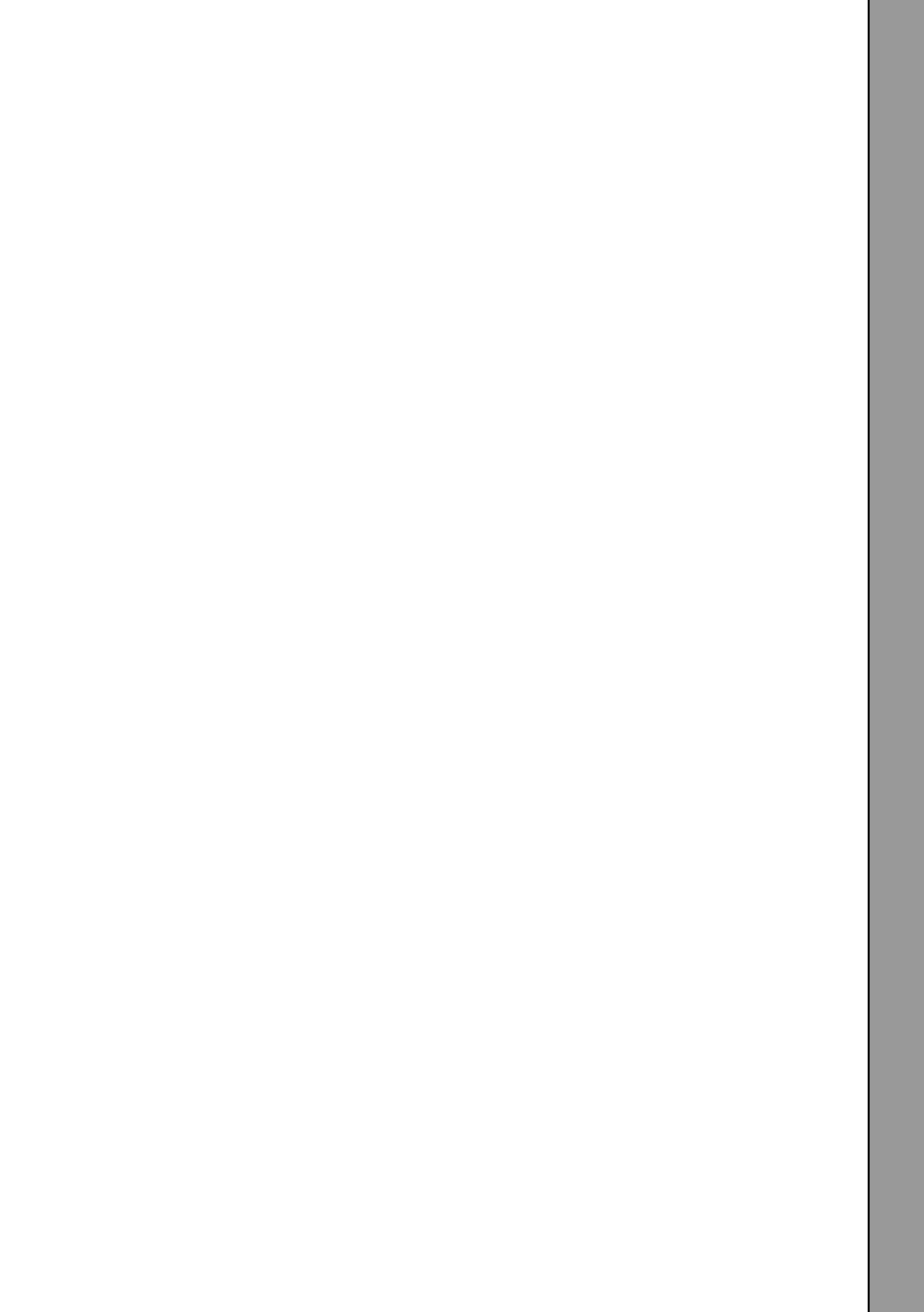

10. THE RUSSIAN BANKING SECTOR: WHAT TO EXPECT?

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1. The past: Russian economic renaissance

Starting from the 1999 Russian economy has went through a stage of a broad-based recovery not only from the effects of the financial crisis of 1998, but also from the deeper effects of institutional transition to the market economy.

Thus, in 1999 Russia has reached the trough of economic contraction phase with a 42.5% cumulative fall of real GDP from the maximum 1990 level, average nominal wages around $60/month, foreign public debt well exceeding 50% of GDP and cumulative foreign exchange reserves at a mere $12.5bn. On the other hand, we have to note that by 1999 Russia has largely completed the process of institutional transition to the market economy, deregulated consumer markets, formed large private companies in strategic sectors of economy. In addition, the economy received a major boost through sharp real devaluation of the ruble.

The combination of such favorable external conditions, low base effect and rather liberal economic policy over the period has created major potential for the fast economic revival, which followed swiftly. Thus, between 1999–2008 average real GDP growth ranged between 6.5%–7%, reaching 10% in 2000. As a result, by 2007 Russian economy has fully recovered from the collapse during the transition process of 1990s.

On early stages of post-crisis recovery the economic growth was supported by robust growth in oil prices and the resulting expansion in trade balance. However, with time the growth was increasingly driven by the robust expansion of domestic demand – both investment and consumption, supported by healthy budget surpluses, robust corporate profits and strong growth in nominal and real wages.

Chart 1: Russia enjoyed strong economic growth
Chart 1a: Strong expansion of domestic demand was the main driver

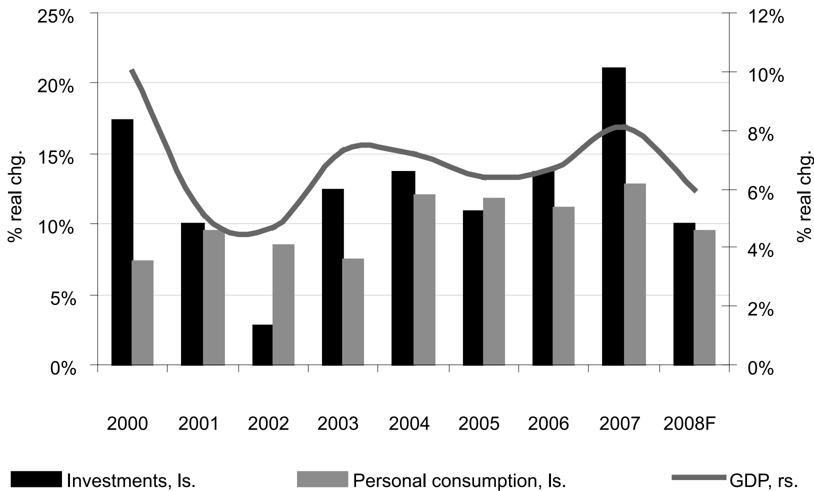
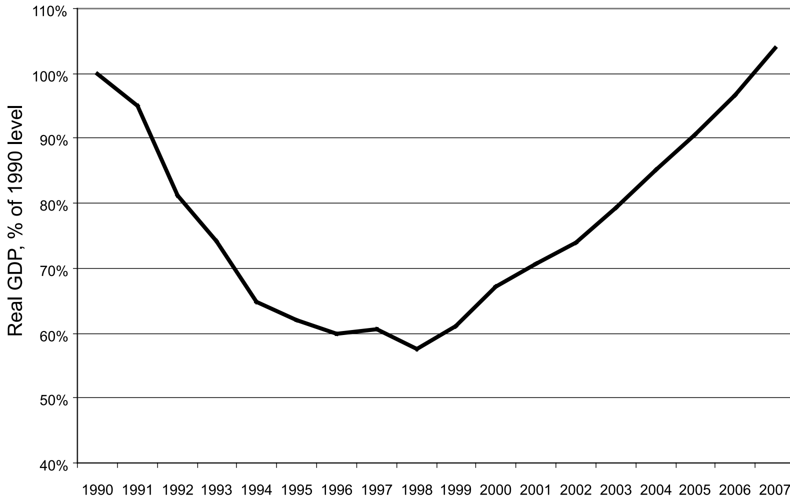


Chart 1b: Allowing the economy to fully recover from 1990's contraction



Source: Federal Statistical Agency

Strong domestic expansion can also be attributed to the effects of continued increases in oil prices, which resulted in a robust expansion of domestic money supply (in the order of 30%–50% per year) boosted by a massive inflows of foreign exchange in the conditions of prevailing fixed exchange rate regime. The continued strength of trade balance and current account helped to solidify such monetary gains and increase their value in foreign exchange, as well as to boost total foreign exchange reserves of the Central Bank, which rose from around $27bn in the end of 2000 to nearly $600bn at their peak in early August 2008.

Chart 2: Rising Oil Prices helped a Lot
Chart 2a: Rising Oil Prices helped to sustain the trade surplus despite rising imports

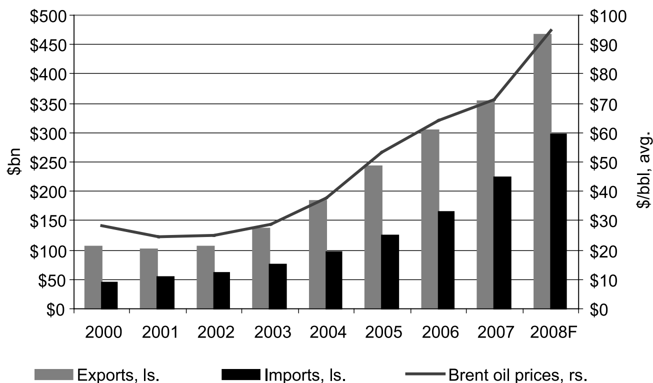
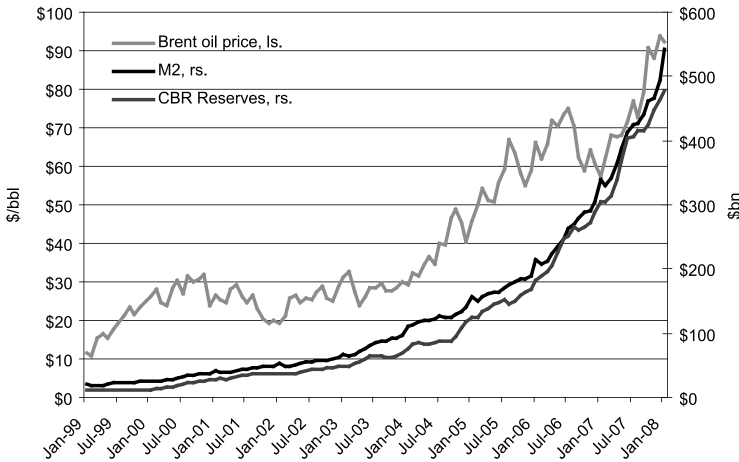


Chart 2b: Rising Oil Prices also boosted money supply and Central Bank reserves



Source: Federal Statistical Agency, CBR, Bloomberg

Healthy economic expansion and abundant money supply clearly proved highly beneficial for the local banking system, which went through a large scale renaissance from the crisis troughs, eventually evolving into an advanced stage of private and corporate business development. Overall, between 2001–2008 the Russian banking system had successfully realized most of growth options which were granted by favorable market conditions and combined investment and consumption boom. Thus, massive growth in corporate profits and disposable incomes was successfully transferred into the rapidly growing domestic deposit base – both private and corporate. Additionally, rapid evolution of local financial system has allowed an explosion of domestic bond market, which greatly contributed to the expansion of local funding base.

The Russian banking system has benefited even more from the globalization and integration into global economy, which greatly compounded positive domestic developments. Banks were among the leaders to tap foreign capital markets in terms of short-term and long term funding, which led to an even greater expansion through inflows of external capital.

Chart 3: Economic Expansion helped the Banking Sector to grow even faster
Chart 3a: Lending activity expanded strongly

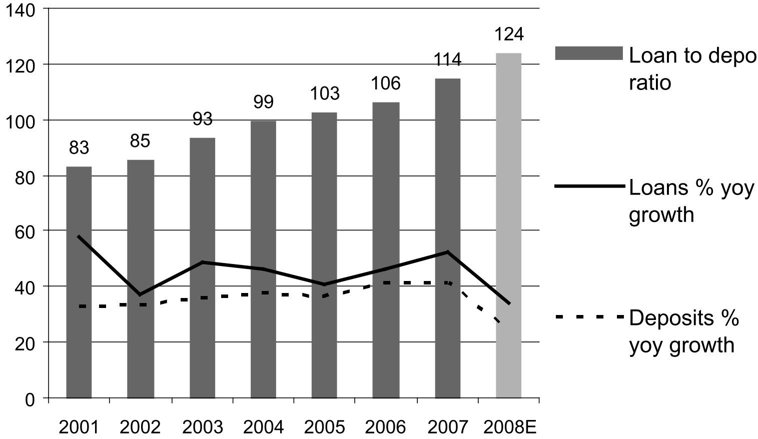
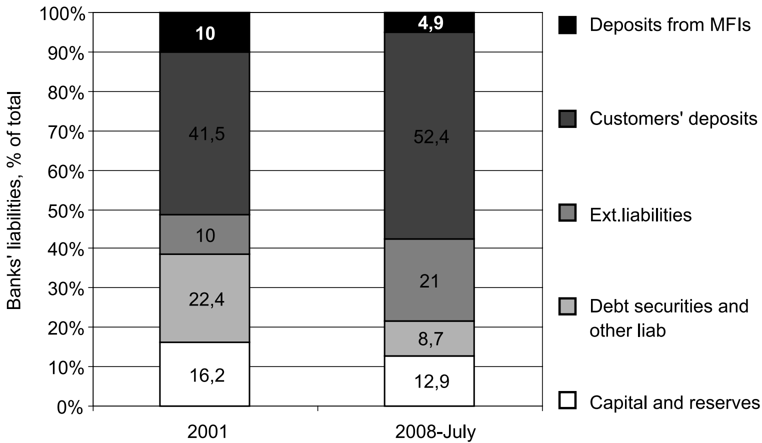


Chart 3b: … financed through increased deposits' mobilization and cross-border lending



Source: Federal Statistical Agency, UCBR research, CEE Strategic Analysis

During this period total banking assets grew more than 10 times with CAGR about 36% y-o-y and reached EUR656bn. Total credit growth was the key driver of this expansion jumping over 13 times between 2000–2008 (CAGR 44%).

Loans to corporate client remained the core business of Russian banking system, which takes nearly 70% of total loans outstanding. However, retail loans started to play an increasingly important role in banking portfolios, demonstrating the

fastest pace of expansion – nearly 42 times since 2001. Although such huge growth rate is mostly attributed to the low base effects, the expansion helped to increase the share of retail loans in total lending from 7% to 22%.

Domestic deposit base also rose strongly benefiting from robust gains in nominal and real disposable incomes as well as corporate profits. By the end of 2008, total deposits in local banking system jumped by over 9 times since 2001 approaching nearly $500bn in size.

Retail deposits - a long time core of customer base for Russian banking sector continued to expand strongly, rising by over 8.5 times since 2001 fuelled by broad-based growth in Russian households' wealth. However, strong growth in global commodities prices, particularly oil (main Russian export commodity) has greatly boosted the profitability of the Russian corporate sectors. The latter contributed to an even accelerated pace of corporate deposits in the Russian banking system, which rose over 13 times since 2001, making corporate deposits the primary source of Russian deposit base. Thus, total size of corporate deposits has exceeded size of retail deposits in 2006 and remain higher by nearly R1900bn or 33% by the end of 2008.

However, strong expansion of deposit base clearly fell short of an ever stronger growth in lending activity. As result the gap between total loans and deposits rose to around 24% in 2008, which was mostly covered by the expansion in external borrowings. The share of the latter rose from 10% in 2001 to 21% in 2008.

Despite protracted integration into global economy, Russian economy remains largely self-sufficient in resources and industrial base. It is also remains relatively independent in the scope of domestic economic, fiscal and monetary policy. The latter boosts some optimism with respect to Russian perspectives and its ability to live through volatile times. As a result of prudent fiscal policy over the past several years, Russian authorities managed to accumulate massive reserves, giving flexibility in policy response to any challenges. In particular, Russian total foreign exchange reserves presently total some $388bn, which still remains the third largest in the world, even after some $200bn decline since August 2008.

In addition, economy in general remains relatively low leveraged as gross foreign debt is presently close to 30%–35% of GDP, whereas public debt is practically non-existent at less than 2% of GDP. Even for the Russian banking sector, despite rising dependency from foreign financing its total exposure

remains quite limited – share of foreign borrowings in total liabilities accounts about 20%.

However, despite some signs of decreasing dependence from global commodities prices, the state of the Russian economy remains highly correlated to the state of global commodities markets, mostly due to the fact that commodities account for nearly 80% of Russian exports (with oil and gas accounting for nearly 67%). In addition, Russian economy is presently going through a long term trend of depopulation, as continued shrinkage of a total and working age population is coming on top of already tight labour supply and rather rigid labour market regulation. Overall, this trends provide strong support to high labour costs of Russian corporate sector, which clearly limit the competitiveness of Russian economy in general.

Moreover, despite the fact that on the overall economy remains relatively low leveraged, some sectors already have rather high exposure to wholesale and foreign funding as it is the case of large commodity producers, large banks, retailers, developers etc. Most importantly, such high leverage is observed among the most dynamic and advanced companies. This clearly makes them highly susceptible to adverse developments on financial markets.

Russian banking system also has problems, which are similar to the problems of broader economy. Thus, domestic sources of funding remain rather insufficient to sustain the current level of growth and even the loan portfolio, which clearly increases the dependence of the Russian banking system from the foreign sources of funding, making the country vulnerable to external shocks.

Also, despite the relatively limited exposure to external capital markets (the share of foreign borrowings in total liabilities accounts about 20%) some segments of Russian banking system clearly have much greater exposure to external financing. For example, share of foreign liabilities in such daughter’s banks of foreign financial institutions as Kommerzbank, KMB–bank (Group Intesa), Orgresbank (Nordea Group), Absolut Bank (KBC Group), Bank Societe Generale Vostok, Credit Europe Bank (FIBA Group), BNP Paribas exceeds 40%. This is also the case for Russian private banks such as MDM-bank, URSA Bank, Promsviazbank, Alfa-bank and Petrocommertz whose share of foreign liabilities exceed 25%.

2. The crisis: politics and economics join forces

In the late Summer 2008, Russian economy and financial system has experienced a perfect storm due to a combination of unfavorable domestic and external factors. Thus, selective attack by authorities on Mechel mining company has revived nearly forgotten fears of Yukos case. In addition, Russian military offensive in the neighboring Georgia and sharp diplomatic standoff with the West, have triggered sharp escalation of nearly non-existent political risks associated with Russia.

These two factors alone have already led to a massive capital flight from Russia in July-September period. However the sharp escalation of global risks aversion during the Fall has greatly compounded the adverse effects. Thus, amid collapsing global equity and fixed income markets Russia, which offered an additional political and administrative risks, turned out to be the worst performing market in the world.

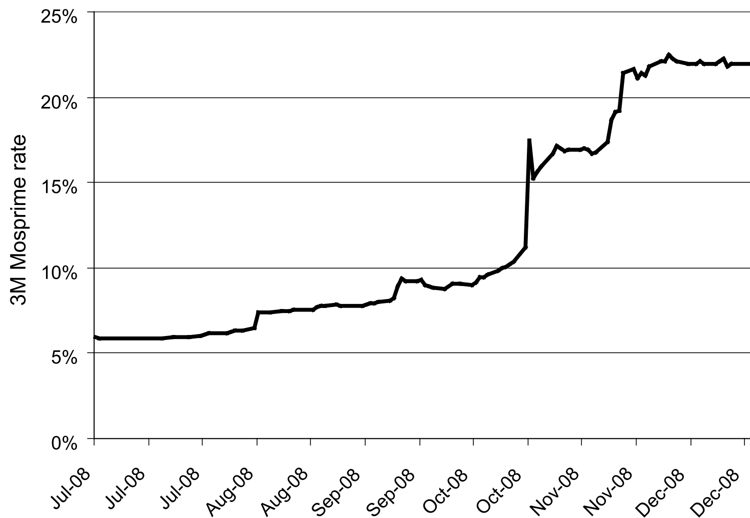
Massive capital flight and sharp negative movements of local financial markets (RTS index lost over 50% in August–September alone, with some shares losing well over 90%) caused significant losses within the banking system and some bank failures (Svyaz Bank, KIT Finance, Globex Bank etc.). Provided the uncertainty over scale of losses among other market participants, the crisis has led to a major confidence crisis and an effective closure of interbank market. This has left a lot of banks with their equity and fixed income assets as the only source of liquidity. The resulting selloff was compounded by technical factors, such as margin calls, forced selling etc, which has greatly intensified the market decline leading to its effective collapse in October.

Coming on top of drastic fall in oil prices, the problems have intensified even further as the Central Bank has chosen to stabilize the ruble and decided to proceed with its fixed exchange rate regime. The problem is that with oil prices falling below $70/bbl, Russian current account is expected to slip into deficit, which drastically deteriorated fundamental support to the local currency. Such rising expectations of ruble devaluation, compounded by already significant capital flight resulted in a major pressure on the Central Bank reserves and drastic tightening of domestic monetary conditions. Thus, interest rates jumped to well over 20% in O/N and 3M Mosprime, whereas in second tier interbank lending the rates have exceeded 50%–60% in O/N

loans. Later on the CBR has decided to proceed with gradual devaluation, allowing 8 (so far) 1%-1.5% devaluations of the ruble against the basket.[1] The move has further worsened the capital flight as expectations of ruble devaluation has started to gain ground and bring profits.

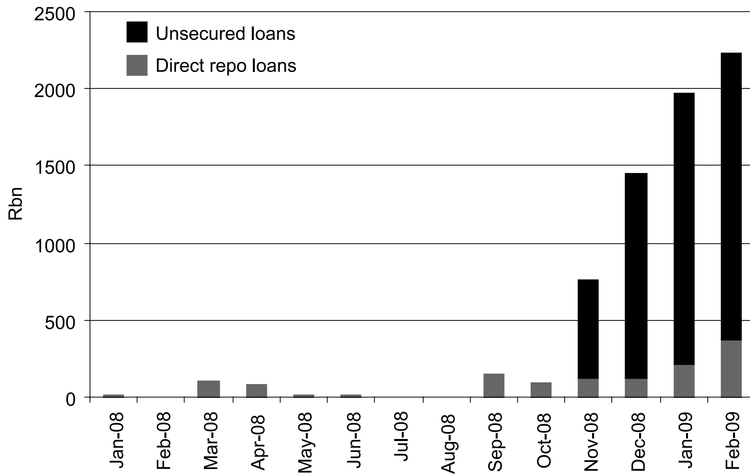
Refinancing efforts by the monetary authorities were largely limited to a few large banks, which received liquidity from the Treasury and CBR. In October-December 2008 Bank of Russia injected EUR83bn of non-collateralized financing into the banking system, which nevertheless have not altered the situation, as most of these money have actually went directly to the FX market, fuelling further pressure on the reserves.

Chart 4: The Collapse of Local Financial Markets closed Local Money Markets
Chart 4a: Market collapse in October and confidence crisis dried up local interbank market



[1] The processes of gradual devaluation and re-dollarization seemed to have ended in late January, when the CBR has set a new support level for the ruble at R41/basket, or nearly 10% below the R37/basket spot level at that time. Although the ruble quickly moved to test the new support level, the limited potential of further ruble devaluation amid tightening of local liquidity provisions by the CBR has greatly undermined further speculative run on the ruble, which has led to a considerable correction of the exchange rate in mid-February.

Chart 4b: … even despite massive liquidity infusions by the Central Bank



Source: CBR, Reuters, UCBR research, CEE Strategic Analysis

Since October 2008 escalating liquidity crisis has started to provoke major squeeze in domestic credit. Corporate loans decelerated from 51% y-o-y in June to 36% y-o-y in December 2008 with retail lending also slowing sharply from 53% y-o-y to 22% y-o-y. The deceleration was to a significant degree driven by expectations of ruble devaluation, which made large banks to sit on their cash reserves, refraining from any uncommitted lines and operating primarily in high margin short term and unsecured loans.

Moreover, escalating confidence crisis in the banking system, coming on top of strong expectations of ruble devaluation has triggered a considerable deposit run by population, as well as corporate sector. As a result, total banking deposits have started not only to decelerate in growth but also contract in absolute terms, falling by 7%–8% from their peaks in August-September.

Deterioration of deposit base has further squeezed available sources of funding for local banks, leaving the infusions from the Central Bank as the last remaining source of liquidity and credit resources.

Chart 5: The Russian Banking Sector Started to Decelerate
Chart 5a: Banks have seen strong deposit runs in October–November

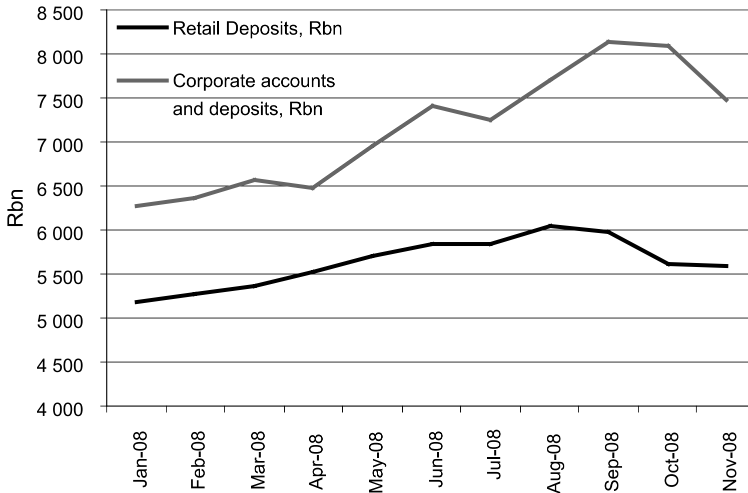
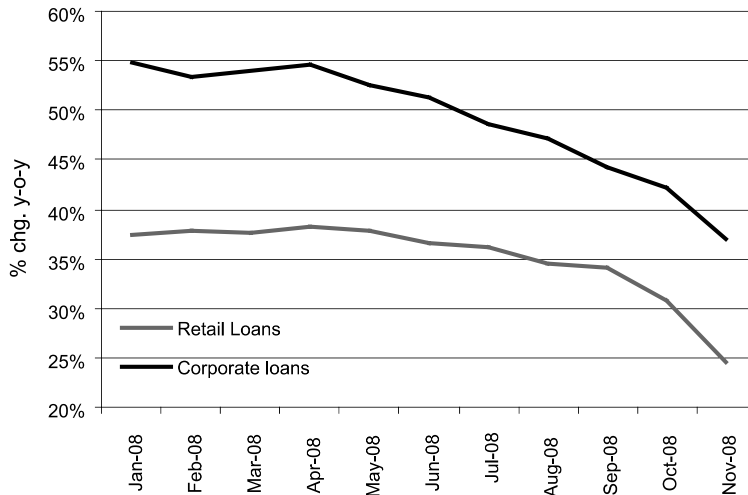


Chart 5b: Lending activity is also slowing fast



Source: CBR, UCBR research, CEE Strategic Analysis

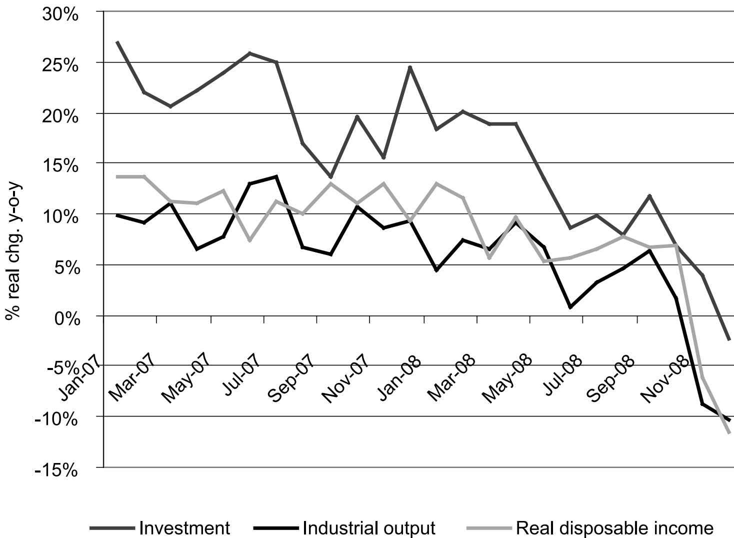
As a result of rising interest rates and intensifying problems with availability of credit, Russian investment demand has started to ease during the Summer of 2008. Thus, by June 2008 investment demand growth in Russia has slowed to single digits in y-o-y terms, down from over 20% y-o-y expansion earlier in the year and in 2007.

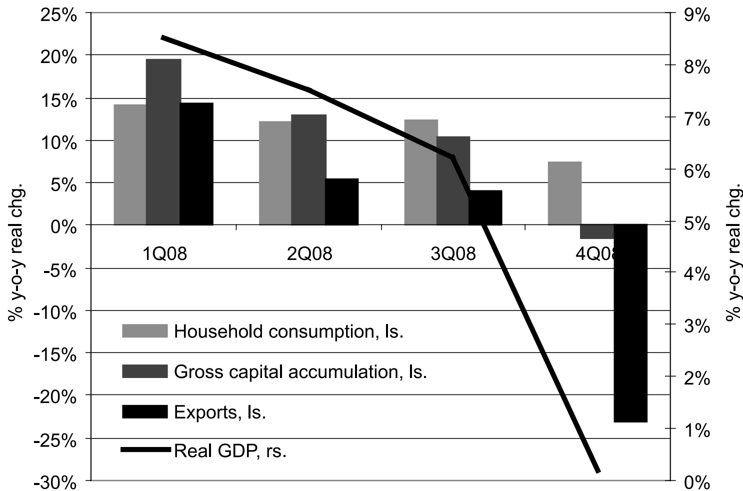
Investment slowdown has started to cool down Russian industrial expansion, which slowed from an average growth of 7.8% y-o-y in February–April 2008 to as low as 0.8% y-o-y in June. Slowing industrial and investment activity in turn have started to ease pressures on the overheated domestic labor market, with the resulting slowdown in real wage and disposable income growth.

Practically all of such adverse trends have greatly intensified with the onset of global liquidity crunch, which further squeezed availability of credit. Another blow came from sharp decline in corporate profits (the last remaining source of investment) due to collapse in global commodities prices and contraction in physical demand for Russian exports (steel products for instance). Thus, in 4Q08 gross profits of Russian economy have fallen by nearly 9.6% y-o-y in absolute terms – the first contraction since early 1998 and the largest on record.

As a result, real and absolute contraction in exports as well as slowdown in investment demand have brought down real economic expansion in Russia to around 0%–0.5% y-o-y growth in 4Q08, down from over 8.5% growth in 1Q08. These trends are likely to intensify further in 1H09 bringing Russia into recession for the first time since 1998.

Chart 6: The Russian Banking Sector started to decelerate - Most important indicators slowed sharply by the end of 2008





Source: CBR, UCBR research, CEE Strategic Analysis

The Russian government has taken strong steps to try to minimize the effects of the crisis on the real economy. The government has pledged over $200bn in response to the crisis (over 12% of GDP), which in relative terms far exceeds the scale of anti-crisis packages in other countries.

The initial goal of the anti-crisis package is prevention of a slowdown in investment growth in Russia, in part by replacing fleeing foreign funds with public money to refinance external debt, support the local banking industry, and help companies exposed to slower investment demand. This goal, however, has evolved into a broad based support for the local banking industry – directly hit by the unfolding crisis, as its stabilization is increasingly seen as a pre-condition for the broader economic recover.

Overall, we expect the government's anti-crisis package to soften the economy's landing. The government's efforts should ward off major defaults by local companies and reduce the risk of bank runs and the further deterioration of the local banking system, while minimizing the social effects of restructuring in sectors hit by the crisis.

However, we believe that even the large-scale public spending as well as banking sector stabilization efforts will be able to fully reverse the decline in investment demand and slowdown economic activity, nor fully and quickly resolve mounting problems in the Russian banking system.

Table 1: The Total Anti-Crisis Package exceeds USD 200bn – or 12% of GDP

Planned amount/ established limit	Actual spending	Goal	Source
Corporate debt refinancing assistance			
$50bn (facility closed)	$11bn	Refinancing the external debts of Russian companies and banks through VEB	CBR reserves
Recapitalization			
$40bn (R1400bn)		Subordinated loans and capital infusions to systemically important banks	National Wellbeing Fund
$34bn (R950bn)	$19bn (R525bn))	Subordinated loans to major banks (SberBank, VTB and others)	CBR, National Wellbeing Fund
$13bn (R365bn)	$13bn (R365bn)	Capital boost for major government banks and institutions	Federal Budget
Liquidity infusion into the banking system			
$100bn (R3500bn)	$52bn (R1860bn as of Feb, 10, 2009)	Unsecured short term lending	CBR
$41bn (R1500bn)	$8bn (R289bn as of Feb, 10, 2008)	Daily direct repo transactions	CBR
	$18bn (R650bn as of Feb 10, 2009)	Other loans	CBR
$14bn (R370bn)	$14bn (R370bn)	Reserve requirement cut	CBR
$13.2bn (R370bn)	$12bn (R336bn)	Short-term deposits by major state-owned corporations	“RosNanoTech”, “RosZhKKh”
Fiscal stimuli			
$15bn (R400bn)	Tax cut in 2009F	Support of investment demand	Federal budget
$6.3bn (R175bn this year, R500bn total)	$3.2bn (R90bn)	Stock and bond buyback to support local financial markets	National Wellbeing Fund
$6bn	Export duty cut in 4Q08	Support for the oil and gas industry	Federal budget
$5bn	Rela estate purchases	Support for real estate and contraction industry	Federal budget

Source: FinMin, CBR, UniCredit Research estimates

Despite the fact the Russian banking system has already faced major problems, risks for further deterioration of domestic conditions remains on the upside. In addition to the inevitable slowdown, possibly even a contraction, of a broader sector growth we think that major problem is likely to be in connection with considerable deterioration of banking asset quality.

In fact, the share of overdue loans has started to rise already. The strongest growth of overdue's share in loan portfolio was observed in corporate loans as financial performance of Russian enterprises dramatically worsen in Q3 2008 affected by contracting consumer demand and unfavorable trade conditions. In opposite to corporate overdue, the share of overdue in retail loans remained quite stable at some 3.1% during Jan-Nov 2008 for the whole banking sector as households wealth was still growing in Q3 2008.

We expect the share of overdue loans to increase further triggered by falling corporate profits, rising unemployment as well as broader economic deceleration with peak of NPL's problem which might be achieved in 2010. NPLs have also started to increase its share in total loans since September 2008 on weaker customers' performance. In reflection to decrease of credit quality, majority of banks definitely have made some adjustments in credit risk policy and increased their LLP stocks.

3. Longer term prospects are brighter

Despite major problems in the nearest 1–2 years, or even more the longer term outlook is more upbeat for a number of reasons. The major one, clearly, is the fact that current economic slowdown and contraction will eventually reach its trough, followed by an inevitable recovery. And as the examples of previous economic cycles always show, the banking sector outlook will be the primary beneficiary of it.

Moreover, Russian banking sector still has a huge growth potential taking into account insufficient monetization of economy and relatively moderate share of banking penetration. The latter clearly leaves a lot of room for further sector expansion, organic development and evolution.

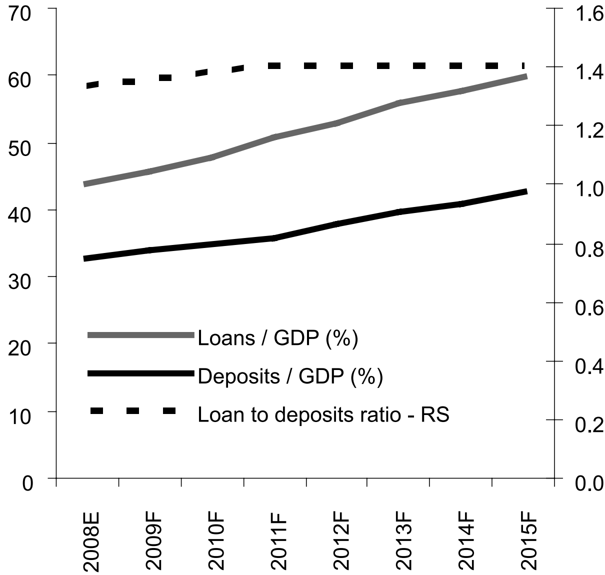
However, such bright perspective will come only after a period of restructuring and adjustment. In particular, in the nearest future banking growth will base mainly on the internal sources of financing, which will most likely lead to a stabilization or even contraction of a gap between lending and deposits' volumes. Given the limited local funding base, this development suggests that slowdown of credit expansion will have a long term character.

Sharp deceleration of lending activity due to limited funding and expected important rise of NLP will affect main indicators of banking efficiency. ROE is expected to deteriorate dramatically and cost of risk to jump in 2009.

It is also evident that this crisis will generate strong transformational impulse for the banking sector, as existing trend of sector consolidation is likely to intensify sharply in the nearest future. As a result, we expect the number of financial institutions to fall by 20–30% during the next 2–3 years. However, sector leaders – centers of such industry consolidation – will clearly enjoy strong expansion in market share. We think that among such banks state and large foreign players have a clear competitive advantage and clearly have greater chances to survive hard times.

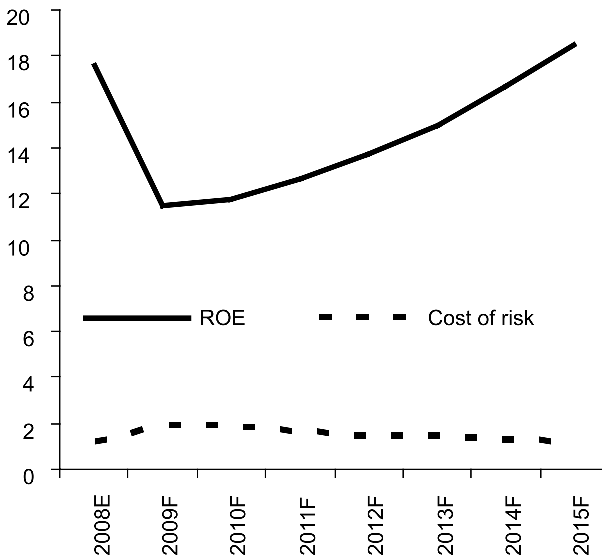
The current deceleration is not a novel event for Russian bank system, which in less than 20 years has already gone through several major crises. Therefore, we can also view the current volatile times as another twist in sector evolution, which will make it stronger and ever more profitable.

Chart 7: Much Brighter Longer Term Prospects
Chart 7a: Banking penetration still has a lot of room to grow†



† at constant 2008 FX rates

Chart 7b: Profitability to resume growth starting from 2010‡



‡ Cost of risk: provisions/average loans' volume
Sources: CBR, Minfin RF, Cbonds.ru, UCBR research, CEE Strategic Analysis

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